SECTION I

U.S.-CHINA TRADE AND ECONOMIC TRANSFERS

The first three chapters of the Report focus on the economic dimension of the U.S.-China relationship. Bilateral trade and investment flows between the two countries are taking place on a massive and rapidly increasing scale. Assessing how these flows are impacting the U.S. economy—and with that U.S. economic security—is an essential area of the Commission's work. In this section, the Commission examines three significant components of U.S.-China trade and investment: China's industrial, investment, and exchange rate policies and their impact in particular on the U.S. manufacturing base, China's record of compliance to date with its World Trade Organization (WTO) commitments, and U.S. financial flows to China via the global capital markets.

Chapter 1 details the ways in which China's industrial, investment, and exchange rate policies are impacting the nature and scope of U.S.-China trade. The chapter focuses on the growing U.S. trade deficit with China, China's undervalued exchange rate, China's mercantilist trade and industrial policies, and the impact of these policies in particular on the U.S. manufacturing sector.

The dominant feature of U.S.-China economic relations is the U.S. goods trade deficit with China, which rose by more than twenty percent in 2003 to a record $124 billion. Over the past ten years, the U.S. deficit with China has grown at an average rate of 18.5 percent, and if it continues growing at this rate, it will double in approximately four years. The U.S. deficit with China now constitutes over twenty-three percent of the total U.S. goods trade deficit, and China is by far the largest country component of the overall U.S. deficit. Moreover, U.S. goods trade with China—with $28 billion in exports to China as compared with $152 billion in imports—is by far the United States' most lopsided major manufacturing trade relationship as measured by the ratio of imports to exports. China is heavily dependent on the U.S. market, with exports to the United States constituting thirty-five percent of total Chinese exports in 2003, while only four percent of U.S. exports go to China. The trade deficit with China is of major concern because (i) it has contributed to the erosion of manufacturing jobs and jobless recovery in the United States, (ii) manufacturing is critical for the nation's economic and national security, and (iii) the deficit has adversely impacted other sectors of the U.S. economy as well.

A key factor contributing to the deficit is the undervaluation of the Chinese yuan against the U.S. dollar, which gives Chinese manufacturers a competitive advantage over U.S. manufacturers. Economic fundamentals suggest that the Chinese yuan is undervalued, with a growing consensus of economists estimating the level of undervaluation to be anywhere from fifteen to forty percent. However, China persistently intervenes in the foreign exchange market to peg its exchange rate at 8.28 yuan per dollar. A second factor contributing to imbalances in U.S.-China trade is China's mercantilist industrial and foreign direct investment policies. These policies involve a wide range of measures including technology transfer requirements, government subsidies, discriminatory tax relief, and limitations on market access for foreign companies. A third factor is China's refusal to recognize workers' rights which results in artificial barriers to wage increases.

Chapter 2 reports on China's progress in meeting its commitments as a member of the WTO. China joined the WTO in December 2001. Its accession agreement is extremely complex, reflecting the need for special arrangements to address the fact that China joined the WTO without having met the requirements of a market economy. To protect against trade distortions and unfair trade practices resulting from China's nonmarket status, the agreement includes a special WTO review mechanism—the Transitional Review Mechanism—to monitor China's compliance and special safeguard provisions giving WTO members the right to protect themselves against sudden surges of Chinese imports. The Commission reviews China's WTO compliance record to date and the effectiveness of U.S. government and WTO monitoring and enforcement measures.

Though China has made progress in reducing tariffs and otherwise formally meeting a large number of its WTO accession commitments, significant compliance shortfalls persist in a number of key areas for U.S. trade. Among areas of concern, the Commission examines China's continued provision of direct and indirect subsidies to Chinese producers, use of unjustified technical and safety standards to exclude foreign products, poor enforcement of intellectual property rights, and discriminatory tax treatment for domestic semiconductor production.

Chapter 3 examines China's presence in the global capital markets, with special focus on equity markets. The Chinese government has selectively chosen firms—predominantly state-owned enterprises (SOEs)—to list on international capital markets, primarily in Hong Kong and New York, and may bring as much as $23 billion in initial public offerings to global capital markets in 2004, a marked increase over the past few years. This process may increase the resources under Chinese government control because the government maintains majority control of these firms, while minority shareholder rights are virtually nonexistent.

Chinese corporate governance standards lag far behind those in the United States. Accounting and reporting standards are weak, and China lacks a sound, transparent system of credit ratings. As a result, even the most sophisticated investors lack adequate information when it comes to Chinese debt and equity listings in the market. This problem is compounded for investors in China-focused mutual funds, which are reliant on their fund managers. Many such funds outsource their research and due diligence to smaller firms in Hong Kong.

Another important issue explored in Chapter 3 is China's WTO commitment to open its financial sector to foreign competition. Owing to years of politically driven, noncommercial-based lending, the Chinese banking system is beset by massive numbers of nonperforming loans (NPLs). Many banks are technically insolvent and it is unlikely that they will be able to compete with foreign banks. Consequently, China appears to be dragging its feet on financial sector opening. These NPLs may also constitute a form of WTO-illegal subsidized capital.

A final area of investigation is the possible nexus between firms listing on U.S. and international capital markets and weapons proliferation and/or China's defense-industrial complex. Many SOEs were previously controlled by the People's Liberation Army (PLA) and there is concern that unofficial links to the PLA remain intact after privatization. One firm listed in China's capital markets (China North Industries Corporation), and available for purchase by qualified U.S. investors, has been sanctioned for proliferation by the U.S. government and there are concerns that other Chinese firms listed or trading in China or the United States may be engaging in similar activities. The Commission examines whether appropriate U.S. government agencies are focused on this problem and sufficiently coordinating responsive measures.

CHAPTER 1

CHINA'S INDUSTRIAL, INVESTMENT AND EXCHANGE RATE POLICIES

"***ECONOMIC REFORMS AND UNITED STATES ECONOMIC TRANSFERS.*** *The Commission shall analyze and assess the qualitative and quantitative nature of the shift of United States production activities to China, including the relocation of high-technology, manufacturing, and R&D facilities; the impact of these transfers on United States national security, including political influence by the Chinese Government over American firms, dependence of the United States national security industrial base on Chinese imports, the adequacy of United States export control laws, and the effect of these transfers on United States economic security, employment, and the standard of living of the American people; analyze China's national budget and assess China's fiscal strength to address internal instability problems and assess the likelihood of externalization of such problems.*" [P.L. 108–7, Division P, Sec. 2(c)(2)(B)]

"***CORPORATE REPORTING.*** *The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China and incentives that China may be offering to United States corporations to relocate production and R&D to China.*" [P.L. 108–7, Division P, Sec. 2(c)(2)(E)]

KEY FINDINGS

- In 2003, the United States ran a goods trade deficit of $535.5 billion, of which $124 billion was attributable to the deficit with China.[1] The U.S. trade deficit with China constituted 23.2 percent of the total U.S. goods trade deficit and China was the largest single country component of the overall deficit. Goods exports to China in 2003 were $28.4 billion, while imports totaled $152.4 billion. China is heavily dependent on the U.S. market, with approximately thirty-five percent of its exports going to the United States, while only four percent of U.S. exports go to China.[2] The magnitude of the goods trade deficit threatens the nation's manufacturing sector, a sector that is vital for national and economic security.
- The U.S. goods trade deficit with China has continued to worsen in 2004. In the first three months of 2004, the deficit rose from $24.7 billion to $ 30.2 billion, a more than twenty-two percent increase. The increase in the Advanced Technology Products (ATP) trade deficit has been proportionately even larger. In the first

three months of 2004, the ATP deficit rose from $3.3 billion to $6.3 billion, an eighty-nine percent increase.

- According to the Bureau of Economic Analysis, U.S. gross domestic product (GDP) growth in 2003 was 3.1 percent, and the worsening of the overall goods trade deficit lowered growth by 0.42 percent. The worsening of the U.S.-China trade deficit accounted for over one quarter of this negative contribution to growth.
- China is systematically intervening in the foreign exchange market to keep its currency undervalued. The undervaluation of the Chinese yuan has contributed to the trade deficit with China and has hurt U.S. manufacturing. This is because an undervalued yuan makes Chinese manufactured goods cheaper in the United States, while making U.S. manufactured goods more expensive in China. The undervalued yuan has also hurt the agricultural sector. Had the Chinese yuan appreciated, as dictated by market forces, this would have made U.S. agricultural products cheaper in China which in turn would have increased Chinese demand for these products. An immediate and significant upward revaluation of the Chinese yuan against the dollar, combined with the removal of discriminatory Chinese trade practices, should help reduce the U.S. trade deficit with China. There is also a need for other East Asian countries (Japan, Taiwan, South Korea) to cease improperly intervening in currency markets to gain competitive advantage. These countries run large trade surpluses with the United States and keep their exchange rates low, in part, to stay competitive with China. If China were to revalue its currency they too would likely adjust. The U.S. Treasury Department has repeatedly downplayed these problems in its semiannual report on international exchange rate policies, resulting in the administration's taking inadequate action against currency manipulation.
- China is continuing to attract massive levels of foreign direct investment (FDI), including $57 billion in 2003. Its policies to attract FDI have been supplemented by industrial policies aimed at developing national productive capacity in selected "pillar" industries. These policies support Chinese corporations through a wide range of measures that include tariffs, limitations on access to domestic marketing channels, requirements for technology transfer, government selection of partners for major international joint ventures, preferential loans from state banks, subsidized credit, privileged access to listings on national and international stock markets, discriminatory tax relief, privileged access to land, and direct support for R&D from the government budget. Such policies give Chinese industry an unfair competitive advantage, thereby contributing to erosion of the U.S. manufacturing base. Many of these policies are not permitted under World Trade Organization (WTO) and U.S. trade rules.
- The textile and apparel industries have suffered enormous trade-related job losses. Employment in textile mills, textile product mills, and apparel has fallen by nearly half over the last decade. The ending of the Multifiber Arrangement (MFA) at the end of 2004 promises to significantly increase U.S. imports of Chinese textile and apparel products and wreak further heavy job loss on these sectors.

- More generally, the problems afflicting U.S.-China economic relations epitomize many of the economic problems surrounding globalization. These include loss of manufacturing jobs, outsourcing of service sector jobs, and international wage competition, all of which put downward pressure on the wages of many U.S. workers. Policymakers need to address the systematic competitive pressures and dislocations that China's policies and practices exert on U.S. labor markets.

OVERVIEW

The overvaluation of the dollar against the world's currencies has been a major contributing factor in the worsening of the U.S. trade deficit over the last several years. Of particular concern is the undervaluation of the yuan against the dollar. China pegs its currency to the dollar, and the yuan has traded at 8.28 per dollar since 1998. During this period, China has experienced massive export sector productivity growth driven by FDI. This situation has enormously strengthened China's competitive advantage, rendering the yuan undervalued. In a free market, China's productivity growth, trade surplus, and inflows of FDI would have caused significant exchange rate appreciation. However, China systematically intervenes in the currency market to prevent this from happening, thereby maintaining an important competitive advantage for Chinese exports.

During the past year, the Commission held several hearings analyzing the impact of U.S.-China trade and investment on the U.S. economy and particularly on the U.S. manufacturing base. The Commission held a hearing on September 25, 2003, in Washington, DC, where testimony was presented by members of the House and the Senate, economists, experts on China's economic development, and representatives of U.S. manufacturing and labor organizations. This hearing focused on (1) China's exchange rate policy and its impact on the U.S.-China trade deficit and U.S. manufacturing activity, and (2) China's investment strategies aimed at attracting FDI.

A field hearing was held on January 30, 2004, in Columbia, South Carolina. It focused on China's impact on the U.S. manufacturing base, with a special focus on China's impact on the textile, apparel, steel, and plastics industries. South Carolina suffered the largest percentage loss of jobs of any state between November 2002 and November 2003, and Columbia suffered the largest percentage loss of jobs for any metropolitan area in the United States.[3] The hearing included a panel on the community effects of a declining manufacturing base. These impacts include loss of local tax bases needed for funding education and essential services. The Commission heard testimony from local political leaders, civic leaders, and business and labor leaders.

The Commission also held a field hearing on *China as an Emerging Regional and Technology Power: Implications for U.S. Economic and Security Interests* in San Diego, California on February 12–13, 2004. This hearing focused on China's high-tech development strategy, China's role in the global supply chain, and the implications for U.S. technological leadership.

ANALYSIS AND FINDINGS

The Imbalanced U.S.-China Trade Relationship and Its Impact on U.S. Manufacturing

The dominant feature of U.S.-China economic relations in 2003 was the goods trade deficit. This widened from $103 billion in 2002 to $124 billion in 2003, a 20.3 percent increase. The trade deficit with China has now grown at an average rate of 21 percent for the last thirteen years, rising from $10.4 billion in 1990 to $124 billion in 2003.

This expansion of the U.S. trade deficit with China occurred in tandem with a worsening of the overall U.S. goods trade deficit. Between 1997 and 2003, the total U.S. goods trade deficit rose from $180.5 billion to $535.5 billion. However, though part of an overall trade deficit problem, there are several features of the China trade deficit that stand out and mark it as qualitatively different and more problematic:

- The China deficit represents 23.2 percent of the overall U.S. goods trade deficit (see figure 1.1 at the end of this chapter). This compares with Japan, which represents 12.3 percent of the deficit, and the eleven countries of the euro area, which represent 14.1 percent.
- In 2003, the total U.S. goods trade deficit rose by $67.2 billion to $535.5 billion, and China accounted for 31.3 percent of the increase. If the U.S.-China goods trade deficit continues to grow over the next five years at an average annual rate of twenty-one percent—as it has since 1990—it will rise to $321 billion in 2008.
- Since 1988, the goods trade deficit with China has grown from $2.8 billion to $124 billion, while the total U.S. goods trade deficit rose from $118.5 billion to $535.5 billion. The deficit with China has therefore become a larger share of the total deficit. Figure 1.2 shows the increasing U.S.-China goods trade deficit and the increasing Chinese share of the total U.S. goods trade deficit. This pattern has two serious implications. First, China is contributing to a higher overall deficit, which costs the United States significant numbers of jobs and reduces economic growth. Second, China is displacing exports from other developing countries, causing problems in those countries.
- The U.S.-China trade deficit represents the United States' most lopsided major manufacturing trade relationship. This can be seen from the country import-export ratios shown in figure 1.3, which show that Chinese imports into the United States are over five times larger than U.S. exports to China. For other major manufacturing trading partners, the ratios are much lower, indicating a better balance between imports and exports.
- U.S.-China trade also raises strategic technology concerns. China is now the largest supplier of advanced technology products (ATP) imports ($29.3 billion in 2003) to the United States, and the U.S. ATP deficit with China is also the largest ($21.0 billion in 2003). Since 1998, the United States has moved from a global ATP trade surplus of $29.9 billion to a global ATP deficit of $27.4 billion in 2003. Figure 1.4 shows the evolution of the U.S. global ATP trade balance and the ATP trade balance with China. The

ATP trade deficit with China now accounts for seventy-seven percent of the global ATP deficit.[4]

- China has taken inadequate steps to correct the imbalanced trade relationship with the United States, including taking no action to revalue its fixed exchange rate. This contrasts with Canada and the euro area countries. This group had a combined goods trade surplus with the United States of $195.8 billion, but their currencies have appreciated significantly against the dollar (see figure 1.5). This stands to reduce future trade deficits by making their products more expensive and U.S. products cheaper. The euro has appreciated by almost thirty-five percent since January 2, 2002.[5]

The expansion of the total U.S. trade deficit and the U.S. trade deficit with China has occurred against a troubling background of "jobless" recovery and continued loss of U.S. manufacturing jobs. Though 2003 was a year of recovery marked by significant GDP growth, the U.S. economy ended it with sixty-one thousand fewer jobs than in December 2002.[6] Especially troubling was the continued loss of jobs in manufacturing, the sector that is most impacted by international trade. Over the course of 2003, manufacturing lost a further 575,000 jobs, ending the year with total employment of 14,324,000. The lion's share of these losses was in durable manufacturing, which lost 363,000 jobs and employment fell to 10,044,000. Manufacturing employment contracted for forty-three consecutive months between July 2000 and February 2004—an unprecedented event. During this period, total manufacturing employment fell from 17.3 million to 14.3 million.

The worsening of the trade deficit, the jobless recovery, and the decline in manufacturing employment are interconnected. The decline in manufacturing employment during the early stages of economic recovery appears to be linked to the new phenomenon of "jobless" recovery. The first jobless recovery occurred in 1991–92, while the second jobless recovery has been in place since 2001. This pattern of jobless recovery from recession marks a break from business cycle recoveries prior to 1991. A salient feature of these two jobless recoveries is the failure of manufacturing employment to rebound. This is shown in figure 1.6, which presents the percentage increase in private employment and manufacturing employment two years into economic recovery for nine business cycles since 1945.[7] In the seven recoveries from 1949 to 1990, manufacturing employment grew robustly as the economy entered the recovery stage. However, in the two recoveries since, manufacturing employment has fallen for a long while into the recovery. In the first jobless recovery, which began in March 1991, manufacturing employment continued falling through October 1992. In the current jobless recovery, which began in November 2001, manufacturing employment continued falling through February 2004. It has expanded in March and April of 2004, but it is still too early to judge the strength of this employment recovery. The uncertainty of this recovery is also indicated by average real hourly wages which fell slightly in the first quarter of 2004 and are essentially unchanged from the level prevailing in December 2001.[8]

The decline in manufacturing employment is in turn linked to the trade deficit. In 2003, the non-petroleum goods trade deficit was $415 billion, versus $375 billion in 2002. This represents an increase of $40 billion. Using an input-output methodology, the Economic Policy Institute (EPI) estimates that in 2000 every $1 billion of imports into the United States embodied 9,500 jobs.[9] Applying this jobs multiplier, the worsening of the goods trade deficit in 2003 cost 380,000 jobs.

A similar calculation can be applied to the China trade deficit, which jumped from $103 billion in 2002 to $124 billion in 2003. Using a job multiplier of 9,500 per billion dollars, the $21 billion increase in the China deficit in 2003 implies a loss of 199,500 jobs. Since 1997, the China trade deficit has risen by $74 billion to $124 billion. Applying the job multiplier, this yields a total loss of 703,000 jobs.

Some argue that the loss of manufacturing jobs is unrelated to the trade deficit and is due to increased manufacturing productivity and a decline in consumption of manufactured goods. The Commission disagrees with this argument. A recent EPI study shows that consumption of manufacturing goods as a share of total demand remains largely unchanged. And though rising productivity and the recession would have reduced manufacturing employment, the trade deficit has also mattered. According to EPI, the increase in the manufactured goods trade deficit accounts for 58 percent of manufacturing job loss between 1998 and 2003 and 34 percent of the loss between 2000 and 2003.[10]

The Importance of Manufacturing

Trade deficit-induced losses of manufacturing jobs represent a major economic and national security concern. As noted by Commerce Secretary Don Evans, "The President believes that our economic and national security require a stable, robust manufacturing sector that produces sophisticated and strategically significant goods, here in the United States."[11]

The manufacturing sector is a major engine of economic growth for the U.S. economy. Two-thirds of R&D spending and more than ninety percent of new patents derive from the manufacturing sector.[12] Productivity growth in the U.S. economy has increased during the last decade, but the increase has been largest in the manufacturing sector, where the rate of increase is twice the rate of the overall economy. Manufacturing is also critical to America's high standard of living, as it is through manufacturing that America pays its way in the world economy. Manufacturing accounts for over eighty percent of U.S. exports of goods, and it accounts for two-thirds of total exports.[13]

A recent study by the National Association of Manufacturing's Council of Manufacturing Associations, *Securing America's Future: The Case for a Strong Manufacturing Base*, warns that "if the U.S. manufacturing base continues to shrink at the present rate and the critical mass is lost, the manufacturing innovation process will shift to other global centers. If this happens, a decline in U.S. living standards in the future is virtually assured."[14] Finally, not only does the loss of manufacturing pose a threat to future standards of living, but it also poses a threat today. Manufacturing jobs pay twenty percent more on average and provide better benefits.

Their disappearance therefore undermines the economic health of America's middle class.

The importance of manufacturing is captured in testimony before the Commission by Franklin J. Vargo, vice president for international economic affairs, National Association of Manufacturers:

> *(t)he United States economy would collapse without manufacturing, as would our national security and our role in the world. That is because manufacturing is really the foundation of our economy, both in terms of innovation and production and in terms of supporting the rest of the economy. For example, many individuals point out that only about three percent of the U.S. workforce is on the farm, but they manage to feed the nation and export to the rest of the world. But how did this agricultural productivity come to be? It is because of the tractors and combines and satellite systems and fertilizers and advanced seeds, etc., that came from the genius and productivity of the manufacturing sector.*
>
> *Similarly, in services—can you envision an airline without airplanes? Fast food outlets without griddles and freezers? Insurance companies or banks without computers? Certainly not. The manufacturing industry is truly the innovation industry, without which the rest of the economy would not prosper.*[15]

These views are shared by the AFL–CIO. In a report submitted as part of the testimony of Richard L. Trumka, secretary-treasurer of the AFL–CIO, before the Senate Committee on Banking, Housing, and Urban Affairs on "The Impact of the Exchange Rate on the United States Balance of Trade, Economic Growth and Employment" held on May 1, 2002, the AFL–CIO states:

> *Loss of manufacturing jobs carries a high cost. Manufacturing is widely recognized as a principal engine of productivity growth, and there is evidence of positive productivity spill-overs from manufacturing to non-manufacturing. There is also emerging evidence that some of the greatest gains from new economy information technologies may come from application of these technologies to manufacturing. Shrinking the manufacturing sector results in a smaller base on which to build productivity growth and on which to apply the new information technologies. Consequently, the U.S. stands to have slower future productivity growth, which will result in a lower future standard of living.*[16]

Trade Dislocations and the Impact on Communities

The loss of manufacturing jobs caused by the U.S. trade deficit has profound implications for many communities. At its Columbia, South Carolina, hearing, the Commission listened to powerful testimony on the extent to which trade-related economic dislocations have impacted many South Carolina manufacturing communities. The Commission was told that the significant loss of jobs in South Carolina due to import competition and off-shoring had resulted in the erosion of the local tax base in many communities. Tax base erosion then contributes to declining law enforcement and infrastructure investment, and declines in the provision of health services, all of which have a debilitating impact on families and quality of life.

As engagement with the global economy grows, it is likely that there will continue to be significant job losses as a result of outsourcing and changing patterns of production. Such job losses often impose large costs on those whose jobs are outsourced. Given that job loss stands to be a permanent feature of the economic landscape, the Commission believes there is a need for new policies to help displaced workers.

Measuring the U.S.-China Trade Deficit

Official U.S. data show a large and growing U.S. trade deficit with China. Official Chinese data show a significantly smaller Chinese trade surplus with United States. According to U.S. data, the deficit was $124 billion in 2003, whereas Chinese data report it as $58.6 billion.[17] This discrepancy has led to claims by the Chinese government that the U.S.-China trade deficit is overstated. However, there are serious concerns about the veracity and reliability of Chinese data.

One reason for the discrepancy is the U.S. practice of treating Chinese exports to Hong Kong that are reexported to the United States as Chinese product, whereas China argues these goods should be counted as an import from Hong Kong. Chinese officials have also argued that U.S. imports from China routed through Hong Kong are overstated because they include value added in Hong Kong.

The Chinese government's approach to counting U.S.-China trade is subject to serious methodological difficulties associated with the problem of "transfer pricing." For the methodology to work, it is vital that goods imported into Hong Kong and reexported to the United States be counted at their proper market value. The current U.S. approach to measuring bilateral trade is not afflicted by this problem and for this reason is superior.

An alternative way of getting an overall picture of U.S. trade with China is to include both China and Hong Kong. According to U.S. data, in 2003 Hong Kong had a trade surplus with the United States of $4.7 billion. Adding this to the $124 billion China deficit figure makes for an adjusted China deficit of $119.3 billion, which is still double the official Chinese estimate of $58.6 billion.

To address these differences, U.S. and Chinese trade officials recently agreed to establish a new working group to try and bridge the gap between how each country measures bilateral trade.[18] Improved data collection is always welcome. However, the Commission is concerned that these efforts not be used by the administration or Chinese government as a way of diminishing the China trade deficit so as to reduce the salience of the problem.

China's Exchange Rate Policies and the Impact on the U.S. Economy

Effect of Misaligned Currencies

International trade is dominated by manufacturing trade, and overvaluation of the dollar has significantly reduced the international competitiveness of U.S. manufacturing industry. This lack of competitiveness is reflected in the growing U.S. trade deficit, which has negatively impacted manufacturing output and employment. The negative effects of the overvalued dollar on manufacturing operate through several channels.[19] First, overvaluation makes exports relatively more expensive, reducing foreign country demand for U.S. manufactured goods. Second, overvaluation makes imports cheaper, inducing a substitution in spending away from domestically produced manufactured goods to foreign-produced goods. Third, overvaluation reduces the profitability of U.S. manufacturing firms by making foreign goods cheaper, and this reduces firms' incentive to invest in new production capacity. Fourth, by making U.S.-based production relatively more expensive, an overvalued dollar gives U.S. companies an incentive to shift production offshore and to build new production facilities offshore.

These negative effects on the trade deficit and manufacturing in turn adversely impact overall U.S. economic growth. According to the Bureau of Economic Analysis, the U.S. goods trade deficit lowered GDP growth by 0.09 percent in 2001, 0.71 percent in 2002, and 0.42 percent in 2003. The trade deficit therefore deepened the recession and is hampering the recovery.[20]

The critical economic significance of exchange rates was summarized in the testimony before the Commission of Franklin J. Vargo; "Only 11 percent of the cost of a U.S. manufactured good is labor. . . . If a product gets a twenty or forty percent price advantage because of a currency, that is a much more significant factor."[21]

The reason is that currency misalignments work on the entire cost base, so that an overvalued currency raises the entire cost structure.

Agriculture and the Dollar

Agriculture is also affected by exchange rates.[22] Approximately twenty percent of U.S. agricultural production is exported to other countries, and agricultural products are commodities.[23] This means competitiveness is crucial, and competitiveness is significantly affected by the exchange rate. The overvaluation of the dollar against most of the world's currencies, combined with the fact that China pegs its currency to the dollar, has meant that U.S. agricultural exports have been rendered less competitive in the China market. This has reduced the benefits to U.S. agriculture of China's entry into the WTO.

An upward revaluation of the yuan against the dollar will make U.S. agricultural products cheaper in Chinese currency terms, thereby increasing Chinese demand for U.S. agricultural exports.

Remedying the Overvalued Dollar and Undervalued Yuan

There is widespread agreement that the dollar has been overvalued against the currencies of the world's major trading countries.[24] With regard to China, the Commission heard testimony that the yuan is undervalued by between fifteen and forty percent.[25] Based on this testimony and other economic evidence, the Commission believes that

- the yuan needs to be revalued substantially upward against the dollar;

- As part of this revaluation, the yuan should be pegged against a trade-weighted basket of currencies to avoid excessive fluctuation against the currency of any single country;
- China should refrain from adopting a floating exchange rate at this time, as its banking system and financial markets are not yet prepared for such an arrangement; and
- China should take active steps to reform its banking system and financial markets to prepare them for an eventual floating exchange rate.

The Case for Revaluing the Yuan

The dollar has now entered a period of correction against the currencies of other industrialized countries. As shown in figure 1.5, since January 2, 2002, it has fallen 33.3 percent against the euro, 16.4 percent against the yen, and 14.4 percent against the Canadian dollar. In addition, it has also fallen significantly against other currencies such as the pound sterling and the Australian dollar. However, there has been no adjustment against the Chinese yuan, which is fixed through official intervention. Additionally, there has been little in the way of correction against the Taiwanese, South Korean, and Singaporean currencies, all of which countries run large trade surpluses with the United States.

This lack of adjustment has occurred despite the fact that there is compelling evidence that the yuan is undervalued. China now constitutes the single largest contributor to the U.S. trade deficit, and economic fundamentals support the claim that the yuan is undervalued. China's economy has been characterized by a trade surplus (external imbalance) and by rapid economic growth with incipient inflation (internal imbalance).[26] A currency revaluation will help restore both trade balance and domestic economic balance by reducing exports and reducing demand for domestically produced goods. Conversely, the U.S. economy has a large trade deficit (external imbalance) and excess capacity and unemployment (domestic imbalance). Dollar devaluation will help restore both external and internal balance by increasing exports and demand for U.S.-produced goods.

A revaluation of the yuan is also needed for global economic equilibrium. As noted above, the United States has significant trade deficits with other East Asian economies, including Taiwan and South Korea. These economies are apprehensive about revaluing their currencies for fear that they will lose competitiveness relative to China. A revaluation of the yuan would likely free this logjam, allowing these economies to revalue too, thereby smoothing and accelerating the process of dollar adjustment.

> *Indirectly, however, China has an additional impact because Japan, South Korea, Taiwan, and others throughout Asia claim they have to intervene and keep their currencies undervalued because of the very low manipulated Chinese rate. In other words, they say they have to manipulate their currencies to remain competitive with China. There is also good reason to believe that if China were to substantially revalue its currency, the other Asians could be persuaded to scale back their Central Bank purchases and allow their currencies to float upward.*[27]

Additionally, failure to revalue China's currency while currencies of other major trading partners appreciate promises to cause economic disruption. This is because other economies—such as Japan and the euro area—are implicitly being forced to take on a larger burden of adjustment to correct the U.S. trade deficit, while the country with the largest surplus (China) undertakes no adjustment.

Arguments Against Revaluing the Yuan Do Not Hold

Some argue that the yuan does not need to be revalued. The Commission rejects this position.

(1) One argument is that revaluing the yuan could lead to a financial crisis in the Chinese banking system that ends up perversely generating a lower value of the yuan. The claim is that opening China's capital account and floating the yuan risks a massive exodus of Chinese savings that could trigger a domestic financial crisis and yuan depreciation. Thus, paradoxically, capital account liberalization and yuan floating could actually cause depreciation rather than appreciation.

However, this argument confuses revaluation of China's exchange rate with a shift to a floating exchange rate. The Commission does not recommend floating the yuan at this time. Instead, China should significantly revalue the yuan upward while maintaining capital controls and a fixed exchange rate over the near term. This would address the underlying balance of payments disequilibrium problem while avoiding financial crisis. China has begun to recognize its problem of domestic financial fragility but must now accelerate the process of remedying it. The fact that capital account opening could trigger a massive outflow of Chinese bank deposits reveals the inhospitable climate of Chinese financial markets for domestic wealth owners. China must therefore move to make its financial assets more attractive. The threat of domestic capital flight is not going to disappear. Indeed, it stands to grow in magnitude as Chinese household financial wealth grows with development and households in turn seek to diversify their portfolios internationally. China must therefore begin enacting measures that make domestic financial assets more attractive. These measures should include corporate and market governance reforms and issuance of an increased supply of attractive domestic financial assets. The bottom line is that China's domestic financial fragility does not justify an undervalued exchange rate that exports deflationary pressures and destroys U.S. manufacturing jobs.

(2) A second argument is that there is no need to revalue, since market forces will force a revaluation despite the Chinese government's exchange rate intervention. This argument is based on the discredited economic doctrine of monetarism. The claim is that China's persistent trade surplus forces its central bank to sell yuan and buy dollars to prevent appreciation and that this expands the money supply, which will in turn cause inflation that drives up Chinese prices. As a result, China will gradually become less competitive, while U.S. manufacturing companies will become more competitive.

The above monetarist argument is flawed. First, even if the mechanism worked, there are long and unpredictable lags between expansion of the money supply and higher prices. In the meantime, American manufacturing firms may be compelled to close down, with consequent loss of jobs. Second, Chinese monetary authorities can take measures to mitigate the effect of a rising money supply on prices. These include raising reserve requirements in the banking system and sterilizing the monetary expansion by selling bonds and thereby withdrawing money from circulation.

(3) A third argument is that the China trade deficit is unrelated to the exchange rate and is the result of a shortage of U.S. saving—principally the result of the large U.S. government budget deficit. The argument is that the U.S. economy is consuming in excess of what it can produce and has to import the balance.

The Commission believes that the United States must address its chronic budget deficits, but it rejects the notion that this obviates the need for China to address its currency undervaluation. Contrary to the claims of the saving shortage hypothesis, the U.S. economy currently has severe excess manufacturing capacity and is capable of producing significantly increased manufacturing output. A shortage of national savings is not the problem. The real problem is that the misaligned exchange rate results in U.S. goods being too expensive relative to foreign goods. This drives down demand for U.S.-produced output, and, over a more extended time period, contributes to the elimination of U.S. manufacturing capacity and the creation of a structural trade deficit. Plant closures and the loss of well-paying jobs in turn undermine the tax base and contribute to state and local fiscal problems.

(4) A fourth argument is that though the United States has a large trade deficit with China, China's overall trade surplus with the rest of the world has been much smaller, and in the first quarter of 2004 it registered a small deficit. Consequently, China's currency may not be undervalued.

Again, the Commission rejects this argument. Figure 1.1 shows that the United States has a trade deficit with every region of the world, and the deficit with China is especially large. This pattern points to a need for a generalized realignment of the dollar, and China should revalue its currency as part of that realignment. Second, for the last several years, China has run a global trade surplus. Moreover, the fact that China has run a surplus even as it grew at nine percent per annum is compelling evidence of undervaluation. Any other country that grew at that rate would have quickly run up a huge trade deficit. The small move into deficit in the first quarter of 2004 reflects continuing breakneck growth and rising commodity prices, particularly in oil. That China still essentially has balanced trade under these conditions is testimony to how undervalued the yuan is. Finally, China is also running a capital account surplus generated by the flood of FDI into China. This means China has an enormous basic balance surplus, defined as the combined surplus on current and capital accounts. Thus, in 2003, China had a current account surplus of $45.9 billion and a capital account surplus of $52.7 billion, making for a basic balance of $98.6 billion.[28] This put significant upward pressure on the exchange rate, but purchases of $116.8 billion of foreign exchange by China's central bank prevented the exchange rate from appreciating.[29]

Prohibitions on Currency Manipulation [30]

By manipulating its currency to keep it artificially low, China effectively gives its exporters an exchange rate subsidy. Such currency manipulation, as discussed below, is illegal under the terms of both China's International Monetary Fund (IMF) and WTO membership. In addition, U.S. trade law also has provisions to address currency manipulation by countries.

With regard to U.S. law, section 3004 of the Omnibus Trade and Competitiveness Act of 1988 requires the Treasury Department to analyze the exchange rate policies of foreign countries, in consultation with the IMF, and to consider whether any countries are manipulating the rate of exchange between their currency and the dollar for purposes of preventing effective balance of payments adjustments or gaining an unfair advantage in international trade. The Treasury is required to report to the Senate Banking Committee twice each year with an assessment of currency manipulation by trading partners. The Secretary of the Treasury is required to undertake negotiations with those countries found to be manipulating their currencies if they are also running a material global current account surplus and a significant bilateral surplus with the United States, unless such negotiations would have a serious detrimental impact on vital national economic and security interests. In its latest report on currency manipulation (April 2004) the Treasury again found that "no major trading partner of the United States met the technical requirements for designation under the Omnibus Trade and Competitiveness Act of 1988." [31] In arriving at this finding, the Treasury gives no indication as to what these technicalities are, and the finding of no manipulation is hard to comprehend in light of the IMF's definition of manipulation as "protracted large scale intervention in one direction in the exchange market."

Currency manipulation is inconsistent with membership in both the IMF and the WTO. Article IV, section 1, of the IMF's Articles of Agreement requires members to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The IMF surveillance provision related to article IV defines currency manipulation as "protracted large scale intervention in one direction in the exchange market." The WTO rules derive from the General Agreement on Tariffs and Trade's (GATT) article XV dealing with exchange rate arrangements, which stipulates that members should not take exchange rate actions that "frustrate the intent of the provisions of this agreement." The intent of the agreement is stated in the preamble, which declares the objective to be "entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade." Moreover, there is a direct linkage between GATT article XV and IMF article IV, since the GATT's "frustrate the intent" test is to be resolved through full consultation with the IMF, and members are instructed to "accept all findings of statistical fact presented by the Fund relating to foreign exchange."

Under IMF and WTO rules, countries are allowed to maintain fixed exchange rates. However, exchange rate parities should be fixed at a level consistent with market equilibrium so that buying and selling pressures should largely balance out. If the exchange rate is set too low, there will be need for protracted, large-scale, one-way market intervention to prevent appreciation. This is the IMF's definition of currency manipulation, and it is how a country maintains an undervalued currency in order to gain competitive advantage.

The evidence shows that there can be little doubt that China has been engaged in extensive, "protracted large-scale intervention in one direction." Such intervention has China's central bank buying dollars in exchange for yuan deposits in the Chinese banking system. Between December 2000 and December 2003, foreign exchange holdings of China's central bank more than doubled from $166 billion to $403 billion. Figure 1.7 reports annual official purchases of foreign exchange by China, Japan, Taiwan, and South Korea, and it shows a strong upward trend. In 2001, Chinese official purchases were $46.6 billion. In 2002, official purchases were $74.2 billion, and in 2003 they were $116.8 billion.

Not only has China's central bank been intervening to hold down the value of its currency but so too have several other East Asian countries. The Bank of Japan's annual official purchases of foreign exchange rose from $40.5 billion in 2001 to $201.3 billion in 2003. Over the period December 2000–December 2003, Japan engaged in even more extensive official intervention and accumulated even more dollar reserves than China. And in January 2004, the Bank of Japan bought a staggering $68.2 billion dollars in just one month. Taiwan has also engaged in persistent protracted official intervention, and in 2003 its holdings of reserves rose by $45 billion to $206 billion. A similar story of persistent intervention can be told for South Korea, and in all cases the problem has worsened over the course of 2003. These developments reveal a systemic exchange rate problem, with the United States' major trading partners in East Asia gaming the system to gain competitive advantage. These practices call for a firm and credible response on the part of the U.S. government that applies to all countries that improperly intervene to hold down currency values.

There is reason to believe that the currency interventions of East Asian countries are closely linked to China's intervention. All fear the economic dislocation that could result from loss of competitive advantage to China, and hence their parallel intervention. The implication is that if China were to revalue upward, other East Asian countries would cease intervening and let their currency values move upward.

Financial Markets, U.S. Interest Rates, and China's Exchange Rate Policy

A final point concerns the implications for U.S. financial markets and interest rates of China's exchange rate policy. For the last several years, China has run large trade surpluses with the United

States. To prevent the yuan from appreciating against the dollar, China has purchased dollars in the foreign exchange market and then recycled these purchases into U.S. financial assets. As a result, China's foreign reserves, which are largely made up of short-term U.S. government liabilities, stood at $420.4 billion at the end of November 2003.[32]

The accumulation of these holdings has strengthened the demand for U.S. government bonds, which has raised their price and lowered their interest rate. Consequently, some fear that if China ceases to intervene in the currency market, this will lower bond prices and drive up interest rates.

This fear is misplaced. First, if China were to cease intervening, the effect on the overall short-term U.S. government bond market would be relatively small given the size of the market. Second, China has been accumulating short-term bills and bonds, and the Federal Reserve can step in if it chooses to and make up for any decline in Chinese purchases.

Whereas ending Chinese currency intervention would have negligible effects on interest rates, a more serious threat comes from the possibility that the People's Bank of China might choose to reallocate its existing portfolio holdings and shift out of U.S. bonds. If this shift were large and sudden, it could cause a spike in U.S. interest rates. Moreover, given the use of derivative contracts and other exotic risk sharing and speculative financial instruments, such a spike could potentially trigger financial turmoil. This is a dangerous economic vulnerability for the United States, and it highlights how sustained trade deficits confer economic leverage on other countries.

China's Industrial and Investment Policies

China's surging exports and trade surplus are based on its rapidly rising industrial capacity. This capacity is in turn built on massive FDI. In 2002, China received $52.7 billion of FDI, and it surpassed the United States as the world's largest recipient of FDI in that year.[33] In 2003, the inflow of FDI was $57 billion, and the total stock of FDI in China now exceeds $400 billion.[34] With inflows anticipated to continue at this level, China will soon be the second largest holder of FDI in the world, after the United States.

The impulse behind the flood of FDI into China is the view held by global corporations that China is central to long-term strategy. Many companies view China as a production platform for exporting to the rest of the world, and they also see China's potentially massive internal market as providing profitable future opportunities. The attractiveness of China as a site for FDI rests on several factors, one of which is the abundance of cheap labor. However, China's mercantilist trade policies and poor labor and environmental policies also play an important role. Thus, the following holds true:

- The maintenance of an undervalued exchange rate keeps production costs low, measured in foreign currency terms. This makes it attractive for global companies to locate export production facilities in China.
- Failure to enforce internationally recognized labor and environmental standards is another source of competitive advantage that is used to attract investment. Just as an undervalued ex-

change rate can lower domestic production costs, so too can a repressive labor system such as China's. That system denies workers' rights of freedom of association and collective bargaining, and it enforces a system of work permits that discriminates against rural workers.

- Policies to attract FDI have been supplemented by industrial policy aimed at developing national productive capacity in selected "pillar" industries. This policy supports Chinese corporations through a wide range of measures that include tariffs, limitations on access to domestic marketing channels, requirements for technology transfer, government selection of partners for major international joint ventures, preferential loans from state banks, subsidized credit, privileged access to listings on national and international stock markets, tax relief, privileged access to land, and direct support for R&D from the government budget.[35]

China's buildup of national and multinational productive capacity raises many concerns. Its rapid increase in export capacity could lead to even larger future U.S.-China trade deficits, making it critical that China be obliged to live up to its WTO obligations and play by the rules of the game. At the sectoral level, the rapid buildup of steel-producing capacity, on the basis of subsidized finance, poses a threat of massive excess capacity in the event of a slowdown in the Chinese economy, which could then be dumped onto the global market.

In the textile and apparel sectors, the imminent end of the Multifiber Arrangement (MFA) on January 1, 2005, risks destroying the remaining U.S. textile and apparel industry, which still employs 713,000 people.[36] According to the American Textile Manufacturers Institute, Chinese apparel imports took fifty-three percent of the U.S. market in June 2003, and this share is projected to rise to seventy-five percent in 2004. Moreover, Mexico and the nations of Central America and the Caribbean are projected to lose one million textile and apparel jobs following the removal of MFA quotas, creating great economic distress and possible social and political unrest.[37] Other major textile-producing nations, such as Bangladesh and Sri Lanka also stand to be affected. Similarly, the economic development benefits of the Africa Growth and Opportunity Act stand to be significantly diminished. This outlook is corroborated by a recent study by McKinsey & Company that predicts that China could account for half of the world's clothing and textile exports by 2008, up from 21.6 percent in 2000.[38] These concerns have prompted textile organizations from thirty-one countries to sign the Istanbul Declaration, which requests the WTO to extend the MFA.[39]

The U.S. auto and auto parts industries represent another sector threatened by China's FDI policies. China now intends to speed up efforts to boost automobile and component exports, according to a senior Chinese trade official. Vice-Minister of Commerce, Wei Jianguo, recently stated that the Chinese government has set an export target of U.S. $70 billion to U.S. $100 billion a year by 2010.[40] The goal is to make China the component supply center for international auto manufacturers. The government plans to take an active role in boosting production by encouraging FDI and encouraging mergers and acquisitions. Auto parts production will stimulate vehicle assembly, while vehicle assembly will stimulate parts production.

Finally, the high-technology sector also faces competitive threats from China. Here, Chinese industrial policy is based on the use of government procurement and of proprietary domestic technology standards. Such standards are put in place as a way of compelling technology sharing and as a way of compelling foreign companies to produce in China if they wish to sell in the Chinese market. This issue is more fully explored in Chapter 7.

China's Economy: What if the Boom Busts?

China has enjoyed an economic boom for the past three years, with annual GDP growth steadily accelerating from 7.3 percent in 2001 to 9.1 percent in 2003. Now, there are fears that China's growth may be unsustainable and may even have elements of a bubble. A particular cause of concern has been a rise in consumer inflation, which rose from negative 0.6 percent in 2002 to 1.2 percent in 2003 and is expected to rise further to three percent in 2004.[41]

China's strong growth performance has been driven by two factors. First, there has been a rapid expansion of domestic credit, driven by lending by state-owned banks. In 2003 and the first quarter of 2004, total bank lending rose at an annual rate in excess of twenty percent.[42] Second, there has been rapid export growth, driven by exports of multinational companies located in China. In 2003, total Chinese exports grew by 34.6 percent, and the multinational share of these exports rose to fifty-five percent.[43] The fact that their share increased indicates that export sales of these companies are rising faster than overall Chinese exports.

In light of fears of accelerating inflation and a possible investment bubble, China's economic authorities have recently moved to slow growth by seeking to check the rate of credit expansion. Slowing an economic boom is a difficult task under any circumstances, but China faces special challenges owing to its suspect credit allocation system.

The core problem concerns lending by China's state-owned banks, much of whose lending is driven by political and noncommercial considerations, some with no expectation of repayment. This has two significant negative consequences. First, it means that many loans are likely to end up as nonperforming, which threatens to undermine further the stability of China's banking system. Second, with loans directed on the basis of political and noncommercial criteria, this finance has sometimes been used to accumulate capacity in sectors already in overcapacity. Consequently, there will continue to be inflationary pressures in sectors short of capacity, while there may be deflationary pressures in sectors where unnecessary capacity has been accumulated.

These problems represent major failings of the Chinese development model. Rapid domestic credit expansion can make for strong aggregate demand growth, while multinational company production can generate exports earnings that provide an international financial cushion. However, ultimately, an economy must make productive investments that ensure capital is accumulated in those places where it is needed and can pay for itself by earning a sufficient rate of return. This calls for market mechanisms.

If China has a significant economic slowdown, the U.S. economy may suffer some collateral damage (as detailed below). Policymakers should be aware of this possibility, but they should also recognize that this damage is likely to be limited. Moreover, concerns about the effects of a Chinese economic slowdown should not be used as reason to avoid addressing existing significant structural problems in the U.S.-China economic relationship.

- Many commodity-producing developing countries have benefited from higher commodity prices resulting from China's increased demand for resources. A Chinese economic slowdown will cause prices to fall back, thereby lowering the incomes of these producing countries and weakening their demand for U.S. exports. Additionally, many developing countries have borrowed on the back of higher commodity prices, and they may have problems meeting their financial commitments, which could then cause problems in global financial markets. Balanced against this, lowering global commodity and oil prices should lower U.S. inflation and benefit U.S. consumers.
- Given China's high rates of investment, funded by state bank lending, there is the prospect of significant surplus capacity in many Chinese industries. This surplus could find its way onto global markets, driving down prices and creating problems for companies in other countries. The steel industry is an instance where such a scenario could readily occur.
- The quantity of nonperforming loans (NPLs) in the Chinese banking sector could increase significantly. These loans should be a concern for equity market investors, particularly small investors whose retirement wealth is at risk. This is because China plans to sell shares in some of its major state-owned banks, and U.S. investors could significantly overpay by buying into these enterprises without full knowledge of the scale of the NPL problem.
- Finally, a slowdown of Chinese economic growth may be used to deflect attention away from China's undervalued currency. As discussed earlier in the chapter, China has a structural trade surplus with the United States that calls for a significant upward revaluation of the yuan. However, in the event of a domestic economic downturn, Chinese authorities may use the downturn to claim opportunistically that adjustment of the exchange rate is inappropriate, as it would compound the slowdown. In effect, China may try to use its internal economic imbalance to block adjustment of its external economic imbalance, with consequent continuing detrimental impact on U.S. manufacturing.

RECOMMENDATIONS

The Commission made additional recommendations on this topic in its transmittal letters to Congress forwarding the record of the Commission's hearings of September 25, 2003, and January 30, 2004, which are attached at appendix II.

Recommendations for Dealing with China's Currency Manipulation

- The 1988 Omnibus Trade and Competitiveness Act requires the Treasury Department to examine whether countries are manipulating their exchange rates for purposes of gaining international competitive advantage. The Treasury is to arrive at its finding in consultation with the IMF, which defines manipulation as "protracted large-scale intervention in one direction in the exchange market." The Treasury has repeatedly evaded reporting on this test. The Commission recommends that Congress require the Treasury to explicitly address this test in its required report to Congress. Furthermore, a condition for taking action against a country that manipulates its currency is that an offending country be running a material global current account surplus in addition to a bilateral surplus. The Commission recommends that Congress amend this provision so that a material global current account surplus is not a required condition.
- The administration should use all appropriate and available tools at its disposal to address and correct the problem of currency manipulation by China and other East Asian countries. With regard to China, this means bringing about a substantial upward revaluation of the yuan against the dollar. Thereafter, the yuan should be pegged to a trade-weighted basket of currencies, and provisions should be established to guide future adjustments if needed. As part of this process, the Treasury Department should engage in meaningful bilateral negotiation with the Chinese government, and it should also engage in meaningful bilateral negotiations with Japan, Taiwan, and South Korea regarding ending their long-standing exchange rate manipulation. The administration should concurrently encourage our trading partners with similar interests to join in this effort. The Commission recommends that Congress pursue legislative measures that direct the administration to take action—through the WTO or otherwise—to combat China's exchange rate practices in the event that no concrete progress is forthcoming.

Recommendations for Addressing China's Mercantilist Industrial and FDI Policies

- The Commission recommends that Congress direct the United States Trade Representative (USTR) and the Department of Commerce to undertake immediately a comprehensive investigation of China's system of government subsidies for manufacturing, including tax incentives, preferential access to credit and capital from state-owned financial institutions, subsidized utilities, and investment conditions requiring technology transfers. The investigation should also examine discriminatory consumption credits that shift demand toward Chinese goods, Chinese state-owned banks' practice of noncommercial-based policy lending to state-owned and other enterprises, and China's dual pricing system for coal and other energy sources. USTR and Commerce should provide the results of this investigation in a report to Congress that assesses whether any of these practices may be actionable subsidies under the WTO and lays out specific steps the U.S. government can take to address these practices.

- The Commission recommends that Congress direct the administration to undertake a comprehensive review and reformation of the government's trade enforcement infrastructure in light of the limited efforts that have been directed at enforcing our trade laws. Such a review should include consideration of a proposal by Senator Ernest Hollings (D–SC) to establish an assistant attorney general for international trade enforcement in the Department of Justice to enhance our capacity to enforce our trade laws. Moreover, the U.S. government needs to place an emphasis on enforcement of international labor standards and appropriate environmental standards.
- The Commission recommends that Congress direct the administration to work with other interested WTO members to convene an emergency session of the WTO governing body to extend the MFA at least through 2008 to provide additional time for impacted industries to adjust to surges in imports from China.

ENDNOTES

1. The figure of $535.5 billion is based on customs data collected by the Foreign Trade Division of the U.S. Census Bureau. For national income accounts purposes, these data are adjusted for certain transactions, and the deficit in 2003 came to $549.1 billion. Source: *U.S. International Trade in Goods and Services January 2004* (U.S. Department of Commerce, March 2004).

2. Commission's calculation using data from the U.S. Census Bureau and U.S.-China Business Council.

3. Dr. Charles W. McMillion, briefing paper prepared for The U.S.-China Economic and Security Review Commission, January 30, 2004, p. 2.

4. Sources: Ernest H. Preeg, *The Growing U.S. Trade Deficit in Advanced Technology Products (ATP)* (Arlington, VA: Manufacturers Alliance/MAPI, March 2004), and data provided by Charles McMillion, MBG Information Services, Washington, DC.

5. The euro closed at 0.89 per dollar on December 31, 2001. Source: Board of Governors of the Federal Reserve, http://www.federalreserve.gov/releases/h10/hist/.

6. In December 2002, total employment was 130,096,000. In December 2003, it was 130,035,000. Source: Bureau of Labor Statistics, http://stats.bls.gov/ces/cesbtabs.htm.

7. The brief cyclical recovery that began in July 1980 is excluded, as it lasted just twelve months and is not representative of a full cycle.

8. Source: Bureau of Labor Statistics, http://data.bls.gov/sevlet/surveyoutputservlet.

9. Based on unpublished data from the Economic Policy Institute, as summarized in Robert E. Scott, "China and the States: Booming Trade Deficit with China will Accelerate Job Destruction in Next Decade with Losses in Every State," issue brief (Washington, DC: Economic Policy Institute, May 2000).

10. J. Bivens, "Shifting Blame For Manufacturing Job Loss" (briefing paper, Washington, DC: Economic Policy Institute, 2004), p. 2.

11. Remarks at the Detroit Economic Club, September 15, 2003, http://www.commerce.gov/opa/speeches/Evans/2003/Sept_15_Evans_manufacturing_Detroit.htm.

12. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment and Exchange Rate Policies: Impact on the United States*, testimony of Ernest H. Preeg, "Chinese Currency Manipulation and the U.S. Trade Deficit," September 25, 2003, p. 74.

13. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, testimony of Franklin J. Vargo on behalf of the National Association of Manufacturers, September 25, 2003, p. 178.

14. The study was prepared by Dr. Joel Popkin, former Council of Economic Advisors member, and is referred to in the testimony of Franklin J. Vargo. See record of the Commission's hearing held September 25, 2003, p. 178.

15. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 178.

16. *The Overvalued Dollar and the Danger to Economic Recovery*, a report submitted as part of the testimony of Richard L. Trumka, secretary-treasurer, AFL–CIO, before the Senate Committee on Banking, Housing, and Urban Affairs, May 1, 2002.

17. "Wu Says U.S., China Agree to Dialogue on Measuring the U.S. Trade Deficit," *Inside U.S.-China Trade*, vol. 4, no. 17 (April 28, 2004): p. 6.

18. "Wu Says U.S., China Agree," p. 1.

19. These effects are documented in R.A. Blecker, "Exchange Rates in North America: Effects of the Over-valued Dollar on Domestic U.S. Manufacturing and Implications for Canada and Mexico," paper presented for the conference "Can Canada and Its NAFTA Partners Conduct Independent Macroeconomic Policies in a Globalized World?" (Ottawa, Canada: University of Ottawa, September 20–21, 2002), and "Overvalued Dollar Puts Hundreds of Thousands Out of Work," (Washington, DC: National Association of Manufacturers, March 2002).

20. Based on figures in figure 1.2 of the Bureau of Economic Analysis's "Gross Domestic Product: Fourth Quarter 2003" release, March 25, 2004.

21. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 220.

22. A recent study confirming the importance of the exchange rate for agriculture is M. Kim and W. Koo, "How Differently Do the Agricultural and Industrial Sectors Respond to Exchange Rate Fluctuation?" (Agribusiness & Applied Economics Report no. 482 (Fargo, North Dakota: North Dakota State University, Center for Agricultural Policy and Trade Studies, June 2002).

23. C.E. Hart, "U.S. Agriculture and the Value of the Dollar," Iowa Ag Review Online, summer 2003 (9.3), www.card.iastate.edu/iowa_ag_review/summer_03.

24. The Institute for International Economics, Washington, DC, published in February 2003 the proceedings of a conference titled *Dollar Overvaluation and the World Economy*. The proceedings document the dollar's overvaluation and the negative economic consequences.

25. Dr. C. Fred Bergsten of the Institute for International Economics estimated China's currency to be under-valued by between twenty and twenty-five percent. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 44. Franklin J. Vargo of the National Association of Manufacturers mentions estimates of under-valuation ranging as high as forty percent: U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 175.

26. China's fast economic growth has recently caused it to move officially into trade deficit. However, this deficit is small, and the fact that it is so small despite a nine percent growth rate, is indicative of the extent of undervaluation.

27. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment and Exchange Rate Policies: Impact on the United States*, testimony of Ernest H. Preeg, September 25, 2003, p. 74.

28. "Double Surplus Situation to Maintain Stability of RMB Exchange Rate: Official," *People's Daily Online*, http://english.peopledaily.com.cn.

29. Source: International Monetary Fund, International Financial Statistics, April 2004, http://www.cbc.gov.tw/EngHome.

30. Material in this section is substantially based on the written statement provided to the U.S.-China Economic Security and Review Commission by Ernest H. Preeg. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, pp. 72–6.

31. *Report to Congress on International Economic and Exchange Rate Policies*, (Washington, DC: U.S. Department of the Treasury, April 15, 2004), p. 1.

32. Source: *IMF Financial Statistics*.

33. Source: *World Investment Report, 2003* (New York and Geneva, Switzerland: United Nations, United Nations Conference on Trade and Development, 2003).

34. Source: U.S.-China Business Council, http://www.uschina.org/statistics/fdi1979-03.html.

35. See prepared statement of Kathleen A. Walsh, senior associate, The Henry L. Stimson Center, U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, pp. 149–50.

36. Source: Commission's calculations using data from the Bureau of Labor Statistics, http://data.bls.gov/

37. These figures are contained in the report *The China Threat to World Textile and Apparel Trade* issued by the American Textile Manufacturers Institute and printed in the record of the Commission's hearing *China's Impact on the U.S. Manufacturing Base* held on January 30, 2004, pp. 49–58.

38. Cited in "China's Rivals in Asia Unprepared for End of Textile Quotas," *AFX News Limited*, March 28, 2004.

39. There were thirty-one signatories as of April 14, 2004.

40. See "Auto Exports to Get Strong Stimulus," *China Daily*, April 5, 2004.

41. All data are from the *Asian Development Outlook, 2004*, (Washington, DC: Asian Development Bank).

42. "Headed for a Crisis?" *Business Week*, May 3, 2004.

43. Data on total export growth are from the *Asian Development Outlook, 2004*. Data on the multinational export share are from a presentation, *Chinese Economy*, by Nicholas Lardy, senior fellow, Institute for International Economics, Washington, DC.

Figure 1.1 U.S. balance of goods trade by region for 2003

	Balance ($ billions)	% of Total
Total (census basis)	**−$535.5**	**100.0%**
North America	**−95.0**	**17.8**
Canada	−54.5	10.2
Mexico	−40.6	7.6
Western Europe	**−101.3**	**18.9**
Euro area	−75.4	14.1
Pacific Rim	**−230.0**	**43.0**
Japan	−66.0	12.3
China	−124.0	23.2
OPEC	**−51.0**	**9.5**
Rest of the World	**−57.9**	**10.8**

Legend: OPEC = Organization of Petroleum Exporting Countries
Sources: Bureau of Economic Analysis and Commission's calculations.

Figure 1.2 U.S.-China goods trade deficit and China's share of the total U.S. goods trade deficit, 1980–2003

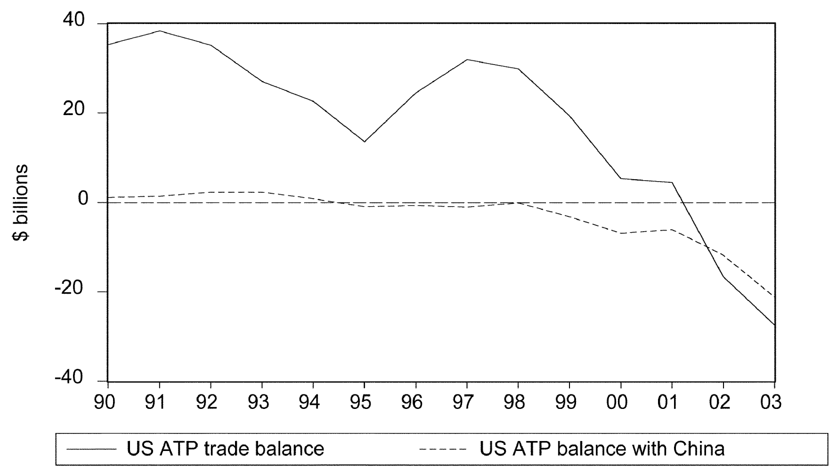
Source: U.S. Census Bureau, Foreign Trade Division.

Figure 1.3 Comparison of scale of imbalance of the U.S. trade deficit by country import/export ratios, 2001–2003

Country	2001	2002	2003
China	5.32	5.66	5.36
Canada	1.33	1.30	1.32
Mexico	1.29	1.38	1.42
EU–15	1.38	1.57	1.63
Japan	2.20	2.20	2.27

Legend: EU = European Union
Sources: Bureau of Economic Analysis and Commission's calculations.

Figure 1.4 U.S. ATP trade balance and U.S. ATP trade balance with China, 1990–2003



Source: Data supplied by Charles McMillion, MBG Information Services and data in *The Threatened U.S. Competitive Lead in Advanced Technology Products (ATP)* (Arlington, VA: Manufacturers Alliance/MAPI, March 2004).

Figure 1.5 Changes in major currency dollar exchange rates, January 2, 2002–April 30, 2004

	January 2, 2002	April 30, 2002	% Change
Euro	0.90	1.20	33.3%
Japanese yen	132.02	110.37	16.4%
Canadian dollar	1.60	1.37	14.4%
Chinese yuan	8.28	8.28	0.0%

Sources: Board of Governors of the Federal Reserve and Commission's calculations.

Figure 1.6 Percentage change in total private and manufacturing employment two years into business cycle economic recovery

	% Change Private Employment	% Change Manufacturing Employment
Oct 1949–Oct 1951	12.00%	16.20%
May 1954–May 1956	7.10	6.10
Apr 1958–Apr 1960	7.20	7.90
Feb 1961–Feb 1963	4.50	5.00
Nov 1970–Nov 1972	6.50	5.80
Mar 1975–Mar 1977	7.20	7.50
Nov 1982–Nov 1984	9.40	7.70
Mar 1991–Mar 1993	1.10	−2.00
Nov 2001–Nov 2003	−1.00	−9.30

Source: Commission's calculations based on Bureau of Labor Statistics data.

Figure 1.7 Annual Official Chinese, Japanese, Taiwanese, and South Korean Foreign Exchange Purchases ($ billions)

Year	China	Japan	Taiwan	S. Korea
2000–01	$46.6	$40.5	$15.5	$6.6
2001–02	74.2	63.7	39.4	18.3
2002–03	116.8	201.3	45.0	33.7

Source: *IMF Financial Statistics* and Commission's calculations.

CHAPTER 2

CHINA IN THE WORLD TRADE ORGANIZATION: COMPLIANCE, MONITORING, AND ENFORCEMENT

"***WORLD TRADE ORGANIZATION COMPLIANCE.*** *The Commission shall review China's record of compliance to date with its accession agreement to the WTO, and explore what incentives and policy initiatives should be pursued to promote further compliance by China.*" [P.L. 108–7, Division P, Sec. 2(c)(2)(H)]

KEY FINDINGS

- China has made some progress in formally meeting its WTO accession commitments, but compliance shortfalls persist in a number of areas of key importance to the United States. While China has generally reduced tariffs in accordance with its accession commitments, it still maintains nontariff barriers and is erecting new nontariff barriers that harm U.S. interests by effectively limiting market access for U.S. goods and services.
- China continues to tolerate rampant piracy of copyrighted U.S. material, with rates running above ninety percent across all copyright industries for 2003.[1] This will cost U.S. industries an estimated $2.6 billion in lost profits in 2004.[2]
- U.S. companies are sometimes forced to transfer technology to Chinese partners as a condition in business deals. The Chinese government violates its WTO obligations when it expressly requires technology transfers as a condition of doing business. It is also able to compel such transfers through use of its regulatory powers as well as its extensive role in the economy. These technology transfers pose substantial economic and security concerns for the United States.
- China has frustrated the effectiveness of the WTO's Transitional Review Mechanism (TRM), thereby preventing it from becoming a robust mechanism for assessing China's compliance and for placing multilateral pressure on China to address shortfalls. The TRM is a central element of China's WTO accession arrangement, and its failure to perform as intended is a serious policy concern that demands attention. China has taken deliberate actions to make the TRM process meaningless and thus must ultimately bear the blame for the TRM's failure. However, the United States and other WTO members are also at fault for allowing the marginalization of the TRM.
- The U.S. government has established mechanisms for monitoring China's WTO compliance but has not been sufficiently vigorous in enforcing U.S. trading rights under U.S. and international trade laws. This insufficient enforcement may dissuade U.S.

businesses from filing trade complaints or safeguard requests, making the use of such measures even less likely. Other potential trade remedies against unfair trade practices, such as countervailing duties, are not being applied to China despite requests by U.S. companies.

OVERVIEW

China was not a market-based economy at the time of its accession to the WTO nor is it now. Because the structures of the WTO rely on the functioning of market-based economies, China's accession required a unique agreement allowing China's early entry in exchange for firm commitments to implement a broad range of legal and regulatory reforms as well as tariff reductions. China also agreed to special safeguard mechanisms that other WTO members could utilize to protect domestic industries significantly injured by surges of imports from China's nonmarket economy. Assuring that China implements its WTO commitments is a large and important task for the U.S. government.

Given the complexity and significance of China's WTO commitments, both the U.S. government and the WTO have established monitoring processes to assess China's compliance progress. At the multilateral level, the WTO's TRM is the central monitoring mechanism. The monitoring systems were also intended to serve as early warning indicators allowing parties to resolve potential disputes. However, they have had only mixed results in this regard.

The focus of the Commission's work in this area has been evaluating the record of China's compliance with its WTO commitments, investigating possible avenues by which the United States can encourage and facilitate improvement in Chinese compliance, and assessing the effectiveness of WTO and U.S. processes for compliance monitoring and enforcement.

The Commission held a hearing on these topics on February 5, 2004. The hearing featured executive branch officials; trade law experts; and representatives of agriculture, business, industry, and labor organizations.

Further, the Commission contracted with the Washington, DC, law firm Stewart and Stewart to produce a comprehensive report, *China's Compliance with World Trade Organization Obligations: A Review of China's 1st Two Years of Membership*. This project is a follow-up to Stewart's April 30, 2002 report for the Commission, *Accession of the People's Republic of China to the World Trade Organization: Baseline of Commitments, Initial Implementation and Implications for U.S.-PRC [People's Republic of China] Trade Relations and U.S. Security Interests*.

A Commission delegation undertook a fact-finding mission to the WTO's Geneva headquarters in December 2003 to discuss with WTO officials, U.S. officials, and representatives of other member countries their perspectives on China's first two years of membership in the WTO. The effectiveness of the TRM process was another central topic of discussion.

ANALYSIS AND FINDINGS

Transitional Review Mechanism Proves Ineffective

As part of its accession agreement, China agreed to be subject to the TRM, a multilateral annual review of China's compliance with its WTO obligations. The TRM is scheduled to produce annual written reports for the first eight years of China's WTO membership, with a final report after the tenth year. It has produced two reports to date.

Congress specifically sought the TRM as part of China's accession agreement, in part because U.S. negotiators expected the TRM to be a robust mechanism for monitoring China's WTO compliance and applying multilateral pressure for improvement.[3] Because the United States was assenting to China's entry into the WTO before its economic and regulatory systems were consistent with WTO norms—i.e., before China had become a fully developed market economy—the United States sought a method for accurately measuring China's implementation of WTO commitments as well as a process for encouraging China's compliance with its obligations. In practice, the TRM has been undermined by China's refusal to abide by standard WTO procedural norms. For instance, China has generally refused to respond in writing to requests for information from other member countries as part of the process. China has also resisted WTO member efforts to have TRM issues raised in WTO subsidiary committee meetings at a sufficiently early stage to have a meaningful dialogue regarding member concerns.

In its report on U.S. efforts to monitor China's WTO compliance, the U.S. General Accounting Office (GAO) concluded: "The TRM process fell short of the meaningful review hoped for by U.S. and other country officials. U.S. government officials agreed that the TRM process would have worked better if there had been greater consensus from WTO members on their expectations regarding China's actions."[4]

China argues that the normal customs of the WTO do not apply, because the TRM is a discriminatory measure applying only to China. The Commission notes that China's entry into the WTO was conditioned on China's acceptance of the TRM and other provisions intended to compensate for the disjunction between WTO standards and China's nonmarket economy. China is therefore obligated to participate in the TRM in good faith, notwithstanding the TRM's application solely to China.

U.S. trade representatives urged China to cooperate more fully following the first TRM report cycle. After experiencing similar noncooperation during the second report cycle, however, the Commission understands that U.S. officials opted not to press the issue on the grounds of hoped-for progress in bilateral dialogue. The Commission expresses deep skepticism regarding such an approach and believes that U.S. officials should press to make the multilateral TRM process more effective.

The Commission is also concerned about the minimal coordination that exists between the United States and other major trading partners regarding China's compliance. The European Union (EU), Japan, and others have not worked together to formulate a joint strategy. Instead, they appear to be waiting for the United States to challenge China on its failings.

China's Compliance Record

China's Obligations

As part of its accession agreement, China was obligated to implement the following salient measures by December 11, 2003:

- Reduce tariffs on most imported goods to rates bound by the WTO accession agreement—this commitment has generally been fulfilled according to schedule.[5]
- Grant full trading rights—the right to import and export—to foreign minority- and majority-owned joint ventures—despite some changes in regulations, this commitment has not been fulfilled.[6]
- Grant distribution rights to foreign minority- and majority-owned joint ventures—this commitment has not been fulfilled.
- Ease geographic restrictions on operations of foreign financial services companies—this commitment has been fulfilled according to schedule.
- Implement a transparent tariff-rate quota (TRQ) system in certain agricultural products—some improvements were made, but problems remain with the nature and transparency of TRQ regulations.
- Permit foreign majority ownership in joint venture retail enterprises and open a number of additional cities to retail joint ventures—this commitment was only partially fulfilled, with foreign investment still problematic in some sectors.
- Permit the use of commission agents for the sale and distribution of the products of foreign majority-owned entities—this commitment has been partially fulfilled, with restrictions remaining.
- Allow foreign majority ownership, and place no geographic or quantitative restrictions on foreign service suppliers of most imported and domestically produced products—this commitment has been fulfilled.[7]

Further commitments to reduce or eliminate barriers to trade, particularly in the area of trade in services, are due to be implemented by December 11, 2004. These commitments relate to such services as commission agents' services, franchising, wholesale and retail operations, telecommunication, banking, insurance, and securities.

China's Compliance Shortfalls

In a series of reports, the executive branch has documented in detail the extent to which China has complied with its accession obligations and other applicable WTO standards. Moreover, Congress has directed the GAO to conduct a multiyear, comprehensive assessment of China's compliance record and U.S. monitoring and enforcement efforts.[8] China has completed a broad range of tariff reductions and legal revisions in accordance with its accession agreement. It has also improved its tariff-rate quota system for agricultural imports and somewhat reduced capitalization requirements for financial service operations.

However, China has also erected new barriers to trade. Additionally, a number of key unaddressed compliance shortfalls continue to significantly impede U.S. trade with China, such as: [9]

- continued direct and indirect subsidies to Chinese producers, including preferred and sometimes unserviced loans from state-owned banks, and free or discounted utility services; [10]
- rampant abuse and lax enforcement of intellectual property rights; [11]
- poor transparency in adopting and applying regulations; [12]
- the use of unjustified safety standards to exclude foreign products—including non-science-based sanitary and phytosanitary (SPS) standards on agricultural products and the China Compulsory Certification of safety; [13]
- the use of unjustified technical standards to exclude foreign products or force foreign producers into joint ventures with Chinese firms for production aimed at the Chinese market; [14]
- denial of equal tax treatment to foreign products;15
- barriers to specific services, such as financial services and express couriers; [16]
- obstacles to domestic distribution of products by foreign companies, which severely curtails the ability of foreign companies to gain market share and forces them to sacrifice control over portions of the profit margin; [17] and
- forced transfers of technology in return for market access or other regulatory approval.

The Commission is particularly concerned about instances in which transfers of technology are required by the Chinese government or state-owned and state-invested enterprises as a condition of establishing a business presence in China. Prior to China's accession, forced technology transfers were a customary part of doing business in China. China agreed to end the practice of government-forced transfers as part of its accession commitments, but the Commission understands that the practice continues.[18] One less direct method for inducing technology transfers is China's use of its licensing power in coordination with its state-owned enterprises to organize bargaining cartels in technology markets.[19] Additionally, because the Chinese government remains extensively involved in the economy, it is in a position to exert pressure toward technology transfers beyond the effects of normal government functions. For example, if a Chinese state-owned or state-invested enterprise requested a technology transfer as a condition of a business deal, the U.S. company involved may be informally told that its broader business dealings in China will be impacted by a refusal to accept this condition. Though it is only a violation of China's WTO obligations if technology transfers are an express condition of the Chinese government for doing business, the Commission is concerned with the cumulative effects on U.S. economic security wrought by transfers of U.S. technology to China.

Reports on Compliance Concur on China's Inadequate Record

U.S. officials, business groups, and analysts have commented on China's mixed compliance record. In 2002–03, agencies of the U.S.

government, the WTO, and a number of U.S. business organizations published studies and submitted testimony assessing China's compliance. The picture that emerges from these reports is that China's record of compliance in its second year in the WTO remains inadequate.

USTR's December 11, 2003, annual report to Congress on China's WTO compliance identified areas in which China had made progress in tariff reduction and implementing certain services and agricultural trade commitments, but concluded:

> *Despite these gains, 2003 also proved to be a year in which China's WTO implementation efforts lost a significant amount of momentum. In a number of different sectors, including some key sectors of economic importance to the United States, China fell far short of implementing its WTO commitments. . . . [I]nstitutionalization of market mechanisms still remains incomplete, and intervention by Chinese government officials in the market is common.*

The USTR report highlighted the following concerns as of the second-year anniversary of China's WTO accession:

Agriculture

- unreasonable rules on biotechnology, notably in the case of soybeans
- questionable sanitary and phytosanitary measures
- apparent use of agricultural subsidies to promote exports
- improper administration of TRQs for bulk agricultural commodities

Intellectual Property Rights

- rampant piracy of film, music, publishing, and software products
- infringements of pharmaceutical, chemical, infotech, and other patents
- counterfeiting of consumer goods, electrical equipment, automotive parts, and industrial products

Services

- transparency problems
- excessive capitalization requirements for foreign financial services companies
- regulatory discrimination in express delivery services
- requirements for insurance companies to form subsidiaries in order to establish branches

Value-added Tax (VAT)

- VAT policies that encourage domestic production over imports in a number of industrial and agricultural sectors
- VAT rebates to domestic semiconductor and fertilizer exporters that disadvantage U.S. exports to China—and third markets—of these products

Transparency

- uncertainty, lack of uniformity in inviting public comment on draft laws and regulations and providing WTO enquiry points

Trading Rights and Distribution Services

- partial implementation of commitments required to be phased in over first three years of WTO membership.

U.S. business groups that lobbied hard in favor of granting Permanent Normal Trade Relations (PNTR) status to China in 1999-2000, and applauded China's entry into the WTO, are now expressing concerns over the pace and scope of compliance. The U.S.-China Business Council, in a recent article, concludes:

> *. . . two years into China's WTO membership, the PRC government has been slow to implement its most significant commitments, and no progress has been made in some important areas. China has fallen into a pattern of renegotiating its WTO entry terms line by line as questions arise about implementation problems. China's interpretations of certain WTO terms violate the spirit, if not the letter, of its commitments, and new barriers China has erected in some areas make matters worse. . . .*[20]

The American Chamber of Commerce in China writes in its 2003 White Paper:

> *. . . there is increasing dissatisfaction with the slow pace of implementing some of China's WTO commitments. As detailed in the relevant sections of this White Paper, there has been little progress in sensitive areas such as financial services, agriculture, and distribution. It should therefore be no surprise that American firms express greater dissatisfaction with WTO implementation than was the case last year, and a higher degree of skepticism about the intentions of the Chinese government.*[21]

The U.S. Chamber of Commerce has called China's WTO compliance "uneven and incomplete," noting further that

> *[u]nless this picture improves, there will be an increasing crescendo of complaints about China's record. A number of companies already publicly express the view that China is dismissive of global trade rules and commitments. . . . [W]e have not seen enough new contracts, new access, and new customers to stem this tide.*[22]

The National Association of Manufacturers says its members

> *want the United States to have a positive trade relationship with China. However, they also want a level playing field for competition. In that regard, we are hearing increasing concerns about unfair Chinese trade and currency practices and China's failure to provide the same kind of access to U.S. goods and services in the Chinese market that Chinese goods and services enjoy in the U.S. market.*[23]

In sum, the Commission finds that though China has made progress regarding its accession obligations, significant gaps remain between commitments and practices. The Commission is concerned about these gaps for two reasons. First, they are affecting access to China's market for U.S. exports. Second, they augur poor implementation of remaining Chinese accession commitments that come due over the next few years.

Combating China's Compliance Shortfalls

The United States has responded to China's compliance shortfalls in four ways. First, it has made modest use of the trade enforcement mechanisms contained in China's accession agreement. Second, it has provided technical assistance to China to improve its implementation of WTO commitments. Third, it has engaged in bilateral dialogue to encourage voluntary reform. Finally, it has filed one WTO dispute against China. Overall, however, the U.S. government has not been sufficiently vigorous in addressing China's compliance problems.

China-Specific Safeguards Remain Underutilized

China's WTO accession agreement included several important safeguards that other WTO members could utilize to protect against surges of Chinese imports following China's entrance into the WTO. These safeguards are not designed to address compliance shortfalls. Rather, they recognize that nonmarket economies lack the necessary mechanisms to adjust production levels in response to changing market conditions. As a result, such economies have a tendency to flood overseas markets with the output from overproduction.[24] The safeguards against import surges were a key aspect of the WTO deal that ultimately made China's accession acceptable to U.S. negotiators and to the U.S. Congress.

(1) The accession agreement allows WTO members to activate a safeguard against specific products imported from China when they cause a "market disruption" in the domestic market. The United States established a procedure for activating this safeguard under section 421 of the Trade Act of 1974. Cases are examined by the International Trade Commission (ITC), which in turn sends a report and recommendation to the president, who can reject an ITC ruling in favor of implementing a safeguard only on national or economic security grounds.[25] This safeguard is available through 2013.

(2) In addition to the product-specific safeguard implemented through section 421, China's accession agreement provided WTO members with a special safeguard against market disruptions from Chinese textile imports. Activating the textile safeguard allows the United States to impose a limit of 7.5 percent on the growth of the offending category of imports from China. The textile safeguard can be activated for one-year periods and is available through 2008.

The United States has made only limited use of the available China-specific safeguards. One instance is the activation of textile safeguards in November 2003 on a limited range of products imported from China. Chinese imports in these textile categories, which account for only five percent of textile imports from China, are currently subject to a one-year growth cap of 7.5 percent.[26] However, the U.S. government has failed to use these safeguards more broadly and did not even publish procedures for implementing the textile safeguard until May 2003, seventeen months after China's WTO entry—a delay that helps to explain the limited use of safeguards but also suggests policy inattention.[27] The textile safeguard will become increasingly important with the termination of the multilateral Multifiber Arrangement (MFA) at the end of 2004. The potential consequences of the imminent end of the MFA are discussed in Chapter 1.

The poor record of the United States on section 421 cases is detailed in figure 2.1. To date, the ITC has reached a determination in five cases and made three affirmative findings with accompanying proposed remedies.[28] The president has rejected each of the affirmative findings. The statute permits such a rejection only if broader national economic or security interests are cited.[29] Affirmative findings by the ITC in section 421 cases were intended to apply presumptively, thereby making the process an important tool for protecting against market disruption.[30] The Commission is now concerned that the effectiveness of the safeguards has been undermined by repeated presidential rejection of trade remedies in section 421 cases. Companies and organizations may cease to file legitimate petitions, given the significant legal costs associated, if they come to believe that even strong cases will be categorically rejected.

The Commission is concerned with the possibility that U.S. petitioners may have been given less access to government decisionmakers on safeguard cases than Chinese respondents. The Chinese government has hired U.S. law and government relations firms to lobby the executive branch during consideration of safeguard requests.[31] Representatives of petitioning U.S. firms allege that they were denied similar access granted to China's interlocutors.[32] USTR has denied that section 421 petitioners had insufficient input or access to the executive branch during the process.[33]

Figure 2.1 Section 421 Investigations by the U.S. International Trade Commission

Product	Investigation Initiated	ITC Vote on Market Disruption	ITC Recommendation	President's Response
Pedestal actuators	August 19, 2002	Affirmative; 3–2	Relief through quotas	Rejected recommendation on grounds of national economic interest [34]
Steel wire garment hangers	November 27, 2002	Affirmative; 5–0	Relief through additional duties	Rejected recommendation on grounds of national economic interest

Figure 2.1 Section 421 Investigations by the U.S. International Trade Commission—Continued

Product	Investigation Initiated	ITC Vote on Market Disruption	ITC Recommendation	President's Response
Brake drums and rotors	June 6, 2003	Negative; 5–0	Not applicable	Not applicable
Ductile iron waterworks fittings	September 5, 2003	Affirmative; 6–0	Relief through a 3-year tariff-rate quota	Rejected recommendation on grounds of national economic interest
Innersprings	January 6, 2004	Negative; 6–0	Not applicable	Not applicable

Source: Information derived from Stewart, China's Compliance with World Trade Organization Obligations, pp. 230–35.

Cooperative Efforts to Encourage Compliance

An example of technical assistance is the Department of Commerce's seminar program that educates Chinese officials about internationally accepted standards and the process for setting standards.[35] A 2001 U.S. government survey found nearly thirty federal departments and agencies engaged in capacity building in China.[36] However, the Commission has been unable to determine if these programs have been effective.

With regard to bilateral trade dialogues, the Commission suggested in its 2002 Report to Congress that U.S. trade negotiators deal with Chinese counterparts at the state council rather than the ministerial level and is pleased to see that trade dialogues are now taking place at this level. The United States continues to utilize the U.S.-China Joint Commission on Commerce and Trade (JCCT). China has elevated the level of JCCT talks by sending Vice Premier Wu Yi to the April 21–22, 2004, meetings. In addition to other ad hoc formal and informal meetings, the United States established the Trade Dialogue in February 2003, which brings together U.S. agencies and Chinese ministries.[37]

China made several important promises at the April 21–22, 2004, JCCT meeting. If indefinitely postponed plans to implement its own wireless Internet standard, which would have acted as a barrier to trade and a mechanism for coercing U.S. companies to transfer proprietary technology. China also pledged to improve its enforcement of intellectual property rights (IPR) and to institute the next stage of market access reforms, as laid out in China's WTO accession agreement, six months ahead of schedule. The Commission notes these promises but remains skeptical in light of similar, unfulfilled promises in the past, particularly in the area of IPR protections. The Commission also notes that a number of important U.S. concerns were not included on the JCCT agenda, including China's exchange rate and labor practices and widespread subsidization of export industries.

The U.S. government has also recently made several organizational changes to address its growing concerns with China's trade practices. USTR has established a new Office of China Affairs to "lead USTR's effort to make sure the United States has fair and open access to China's markets."[38] The Treasury Department appointed Ambassador Paul Speltz to the position of economic and financial emissary to China.[39] The Commission hopes these changes will allow the government to better manage the U.S. response to addressing trade concerns with China.

The United States Files First WTO Dispute

The United States filed its first WTO dispute against China in March 2004 challenging its value-added tax on semiconductors, and the European Union and Japan joined the case as coplaintiffs in April 2004. China maintains a seventeen percent value-added tax on semiconductors but provides a rebate for sales of domestically designed and manufactured semiconductors, making the effective domestic tax rate three percent. Foreign-designed but domestically manufactured semiconductors are subject to an effective tax rate of six percent. China maintains these differential tax rates in order to force leading-edge semiconductor manufacturers to move production to China.[40] The United States believes that this practice violates the WTO's national treatment principle and has entered into formal consultations with China as the first step in its WTO dispute. Informal consultations on the issue have been held since China's accession, but they have ultimately proved fruitless due to China's contention that its practices are WTO-consistent. How China responds to this case is an important test of China's membership, and other WTO members appear to have been waiting for the United States to take the lead in confronting Chinese trade practices.[41]

The Commission believes that the United States has not pursued its trade rights sufficiently aggressively under either the WTO or domestic trade laws and that the time for restraint and forbearance has passed.

In addition to more vigorous application of China-specific safeguards and use of the WTO dispute resolution mechanisms, the United States should consider new options for inducing improvement in China's trade practices. One option is to adjust U.S. practices or statutes to allow countervailing duties to be levied against nonmarket economies. The Department of Commerce currently labels China a nonmarket economy, a classification that U.S. negotiators worked hard to maintain during China's accession process. Under existing Commerce rules, countervailing duties cannot be applied to nonmarket economies. The Department of Commerce can change this rule and make countervailing duties applicable to nonmarket economies without affecting China's nonmarket status in antidumping cases.[42] If Commerce declines to do so, Congress should legislate the applicability of countervailing duties to China. Countervailing duties are an important tool for the protection of domestic industry from subsidized imports.

The U.S. government has still other important trade law remedies for combating unfair Chinese trade practices. For instance, the AFL-CIO filed a petition in March 2004 asking USTR to initiate a section 301 investigation of China's labor practices.[43] The petition could have triggered a USTR investigation to determine if

China's labor practices are "unjustifiable and burden or restrict United States commerce." Section 301 of the 1974 Trade Act grants USTR the capacity under U.S. trade law to impose punitive measures in an effort to correct unfair trading practices of U.S. trade partners.[44] In April 2004, USTR refused to investigate China's labor practices, claiming that the United States would achieve better results with the administration's strategy of utilizing negotiations and more selective use of enforcement mechanisms.[45]

RECOMMENDATIONS

The Commission made additional recommendations on this topic in its transmittal letters to Congress forwarding the record of the Commission's hearings of September 25, 2003, and February 5, 2004, which are attached at appendix II.

- The Commission recommends that Congress press the administration to make more use of the WTO dispute settlement mechanism and/or U.S. trade laws to redress unfair Chinese trade practices. In particular, the administration should act promptly to address China's exchange rate manipulation, denial of trading and distribution rights, lack of IPR protection, objectionable labor standards, and subsidies to export industries. In pursuing these cases, Congress should encourage USTR to consult with trading partners who have mutual interests at the outset of each new trade dispute with China.
- The Commission recommends that Congress press the administration to make better use of the China-specific section 421 and textile safeguards negotiated as part of China's WTO accession agreement to give relief to U.S. industries especially hard hit by surges in imports from China.
- Notwithstanding China's commitments at the April 2004 JCCT meeting, the Commission recommends that Congress press the administration to file a WTO dispute on the matter of China's failure to protect intellectual property rights. China's WTO obligation to protect intellectual property rights demands not only that China promulgate appropriate legislation and regulations, including enacting credible criminal penalties, but also that these rules be enforced. China has repeatedly promised, over many years, to take significant action. Follow-through and action have been limited and, therefore, the Commission believes that immediate U.S. action is warranted.
- The Commission recommends that Congress urge the Department of Commerce to make countervailing duty laws applicable to nonmarket economies. If Commerce does not do so, Congress should pass legislation to achieve the same effect. U.S. policy currently prevents application of countervailing duty laws to nonmarket economy countries such as China. This limits the ability of the United States to combat China's extensive use of subsidies that give Chinese companies an unfair competitive advantage.
- The Commission recommends that Congress encourage the administration to make a priority of obtaining and ensuring China's compliance with its WTO commitments to refrain from forced technology transfers that are used as a condition of doing

business. The transfer of technology by U.S. investors in China as a direct or indirect government-imposed condition of doing business with Chinese partners remains an enduring U.S. security concern as well as a violation of China's WTO agreement. A WTO complaint should be filed when instances occur.

- The Commission recommends that Congress encourage USTR and other appropriate U.S. government officials to take action to ensure that the WTO's Transitional Review Mechanism process is a meaningful multilateral review that measures China's compliance with its WTO commitments. If China continues to frustrate the TRM process, the U.S. government should initiate a parallel process that includes a specific and comprehensive measurement system. The United States should work with the European Union, Japan, and other major trading partners to produce a separate, unified annual report that measures and reports on China's progress toward compliance and coordinates a plan of action to address shortcomings. This report should be provided to Congress. In addition, independent assessments of China's WTO compliance conducted by the U.S. government, such as USTR's annual report, should be used as inputs in the multilateral forum evaluating China's compliance, whether that forum is a reinvigorated and effective TRM or a new process.
- The Commission recommends that Congress consider options to assist small-and medium-sized business in pursuing trade remedies under U.S. law, such as through section 421 cases.

ENDNOTES

1. U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of Eric H. Smith, February 5, 2004, p. 136.
2. Neil King Jr., "China Agrees to Curb Piracy of U.S. Goods," *Wall Street Journal,* April 22, 2004, A–2.
3. U.S.–China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of Charles Freeman, February 5, 2004, p. 27.
4. U. S. General Accounting Office, *World Trade Organization: First-Year U.S. Efforts to Monitor China's Compliance,* GAO–03, 461 (Washington, DC: March 31, 2003).
5. China's average tariff rate is currently 10.4 percent and will be reduced to 9.8 percent by 2010 if China's WTO accession agreements on the matter are implemented. "China Cutting Average Tariff Rate to 10.4%," *China Daily,* January 2, 2004.
6. China committed to granting trading and distribution rights to foreign minority-owned joint ventures by December 11, 2002. For this and the following bullet, the December 11, 2003, deadline applies to foreign majority-owned joint ventures.
7. United States Trade Representative, *2003 Report to Congress on China's WTO Compliance* (Washington, DC: December 11, 2003); see also GAO, *World Trade Organization: Analysis of China's Commitments to Other Members,* GAO–02–1056 (Washington, DC: October 3, 2002); and Julie Walton, "WTO: China Enters Year Three," *China Business Review,* vol. 31, no. 1 (Jan.-Feb. 2004). For a more comprehensive analysis of China's obligations, see Stewart, *Accession of The People's Republic of China to the World Trade Organization.*
8. GAO, *World Trade Organization: First-Year U.S. Efforts to Monitor China's Compliance.*
9. See the record of the Commission's hearing on *China and the WTO: Compliance and Monitoring,* held on February 5, 2004. See also USTR's *2003 Report to Congress on China's WTO Compliance,* the report by Terence P. Stewart, and the numerous reports of industry groups.
10. National Association of Manufacturers (NAM), *Review of China's Compliance with its WTO Commitments,* (Washington, DC: NAM, September 10, 2003); and

Wayne M. Morrison, *China and the World Trade Organization,* Congressional Research Service Report to Congress (Washington, DC: August 6, 2003).

11. International Intellectual Property Alliance's *2003 Special 301 Report: People's Republic of China* (Washington, DC: February 13, 2004). Available at www.iipa.com/rbc/2004/2004SPEC301CHINA.pdf.

12. U.S.-China Business Council, *China's WTO Implementation: a Mid-Year Assessment* (Washington, DC: 2003); and Robert Vastine, *Progress of China's Compliance with WTO Commitments to Liberalization of Trade in Services,* Coalition of Service Industries, Statement to the Trade Policy Staff Committee (Washington, DC: October 3, 2003).

13. National Electrical Manufacturers Association, *Statement by the National Electrical Manufacturers Association (NEMA) for TPSC (Trade Policy Staff Committee) Review of China's Compliance with its World Trade Organization (WTO) Obligations* (Washington, DC: September 18, 2003); U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of Robert Carlson, February 5, 2004, p. 109; and United States Council for International Business, *China WTO Written Comments: Trade Policy Staff Committee* (Washington, DC: September 10, 2003).

14. Information Technology Industry Council Press Release, "Top Administration Officials Challenge Chinese WLAN Standard" (March 4, 2004). Available at www.itic.org/2003prs/040304.2.htm.

15. Semiconductor Industry Association, "SIA Issue Backgrounders: China." Available at www.semichips.org/backgrounders—china.cfm

16. William B. Abnett and Robert B. Cassidy, *China's WTO Accession: The Road to Implementation,* National Bureau of Asian Research Special Report, No. 3 (Seattle, WA: November 2002).

17. U.S. Chamber of Commerce, *China's WTO Record: A Two-Year Assessment* (Washington, DC: September 18, 2003).

18. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment and Exchange Rate Policies: Impact on the U.S.,* Testimony of Kathleen Walsh, September 25, 2003, p. 161.

19. U.S.-China Economic and Security Review Commission, *Hearing on China as an Emerging Regional and Technological Power: Implications for U.S. Economic and Security Interests,* testimony of Peter Cowhey, February 13, 2004, p. 17.

20. Walton, "WTO: China Enters Year Three."

21. American Chamber of Commerce in China, *2003 White Paper on American Business in China.*

22. Myron Brilliant, *China's WTO Record: A Two-Year Assessment* (statement prepared October 3, 2003, for the Interagency Trade Policy Staff Committee).

23. The National Association of Manufacturers, *Review of China's Compliance with its WTO Accession Commitments* (comments submitted to the interagency Trade Policy Staff Committee, September 10, 2003).

24. U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of Robert Cassidy, February 5, 2004, pp. 63–4.

25. U.S. International Trade Commission, *Understanding Safeguard Investigations.* Available at www.usitc.gov/us201.htm.

26. Peter S. Goodman, "China Assails Import Limits," *Washington Post,* November 20, 2003.

27. U.S.-China Economic and Security Review Commission, *Hearing on China 's Impact on the U.S. Manufacturing Base,* testimony of Norman Chapman, January 30, 2004, p. 32.

28. Findings available from the ITC, "Investigations Under Section 421 of the Trade Act of 1974." Available at www.usitc.gov/7ops/chinasafeguard.htm.

29. The statue governing section 421 cases instructs the president to take into account, *inter alia,* "(D) the probable effectiveness of the actions authorized under paragraph (3) [options for import relief] to facilitate positive adjustment to import competition; (E) the short- and long-term economic and social costs of the actions authorized under paragraph (3) relative to their short- and long-term economic and social benefits and other considerations relative to the position of the domestic industry in the United States economy; (F) other factors related to the national economic interest of the United States, including, but not limited to: (i) the economic and social costs which would be incurred by taxpayers, communities, and workers if import relief were not provided under this part, (ii) the effect of the implementation of actions under this section on consumers and on competition in domestic markets for articles, and (iii) the impact on United States industries and firms as a result of international obligations regarding compensation." U.S. Code, title 19, chapter 12, section 2253.

30. U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of Robert Cassidy, February 5, 2004, p. 65.

31. U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of Terence P. Stewart, February 5, 2004, p. 68.

32. House Appropriations Subcommittee for the Departments of Commerce, Justice, State, the Judiciary, and Related Agencies, Hearing on *The Effects of Chinese Imports on U.S. Companies,* testimony of William Wolf, May 22, 2003.

33. House Appropriations Subcommittee for the Departments of Commerce, Justice, State, the Judiciary, and Related Agencies, Hearing on *The Effects of Chinese Imports on U.S. Companies,* testimony of Deputy USTR Peter Allgeier, May 22, 2003.

34. In order to reject the suggestion of the ITC to provide import relief, the president must supply a detailed explanation to Congress. Presidential explanations for each case can be found in the report by Terence P. Stewart, page 230. In each of the three cases, the president's explanation considered relief to be either ineffective or outweighed by negative impacts on U.S. producers and consumers.

35. U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of James Jochum, February 5, 2004, p. 11.

36. Stewart, *China's Compliance with World Trade Organization Obligations.*

37. USTR press release, "USTR Zoellick to Visit China February 17–20 to Discuss WTO Impact, China's Implementation, and Bilateral Trade Issues" (Washington, DC: February 14, 2003). Available at http://www.ustr.gov/releases/2003/02/03-09.pdf.

38. USTR press release, "USTR Announces New China Office, Other Organizational Changes" (Washington, DC: April 13, 2004). Available at www.ustr.gov/releases/2004/04/04-31.pdf.

39. Department of the Treasury press release, "Secretary Snow Appoints Ambassador Paul Speltz as Economic and Financial Emissary to China" (Washington, DC: April 14, 2004). Available at www.ustreas.gov/press/releases/js1325.htm.

40. U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Compliance and Monitoring,* testimony of Anne Craib, February 5, 2004, p. 141.

41. The Commission heard this opinion expressed frequently during its discussions with WTO officials and member country representatives in Geneva. For example, the European Union and Japan only joined the semiconductor case after the United States took decisive action.

42. Stewart and Stewart Law Offices, *Application of U.S. Countervailing Duty Laws to NMEs [Nonmarket Economies] (Particularly China): Time for Change* (Washington, DC: April 8, 2004).

43. AFL–CIO press release, "AFL–CIO Challenges Bush on China Trade Abuses" (Washington, DC: March 16, 2004). Available at www.afl-cio.org/mediacenter/prsptm/pr03162004.cfm.

44. Section 301 investigations can also judge whether another country's practice "violates, or is inconsistent with, the provisions of, or otherwise denies benefits to the United States under, any trade agreement." This provision is contained in section 301(a)(1)(A)(i). A January 2000 WTO ruling established that any investigations by the USTR into alleged violations of WTO agreements would have to be pursued within the WTO's dispute resolution framework. The ruling neither considered nor circumscribed the ability of the USTR to examine and act on a trading practice that "is unjustifiable and burdens or restricts U.S. commerce," as covered in section 301(a)(1)(A)(ii). Ultimately, however, any punitive measure imposed by the United States that falls within the issue areas addressed by the WTO would be open to a WTO dispute. The language regarding section 301 cases can be found in the U.S. Code, title 19, chapter 12, section 2411. Jean Heilman Grier of the Office of Chief Counsel for International Commerce (Department of Commerce) prepared an explanation, "section 301 of the 1974 Trade Act," in October 2001 that explains the processes and limits of section 301 investigations. It is available at www.osec.doc.gov/ogc/occic/301.html.

45. USTR press release, "Statement of U.S. Trade Representative Robert B. Zoellick on U.S.-China Trade Relations" (Washington, DC: April 28, 2004).

CHAPTER 3

CHINA'S PRESENCE IN THE GLOBAL CAPITAL MARKETS

"***UNITED STATES CAPITAL MARKETS.*** *The Commission shall evaluate the extent of Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests.*" [P.L. 108–7, Division P, Sec. 2(c)(2)(D)]

"***CORPORATE REPORTING.*** *The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China.*" [P.L. 108–7, Division P, Sec. 2(c)(2)(E)]

KEY FINDINGS

- China is engaged in a process of selective listing of companies in U.S. capital markets. The vast majority of funds raised by Chinese firms listing in the United States—more than ninety percent—has been for state-owned enterprises (SOEs), even though the Chinese private sector accounts for roughly sixty percent of Chinese GDP.[1] By raising funds in the global capital markets, SOE listings increase the total value of financial resources under the Chinese government's control, since the government retains majority shareholder control, while minority shareholder rights are virtually nonexistent.
- Since May 2003, China has permitted qualified foreign institutional investors (QFIIs) to invest in its renminbi-denominated A-share market. This allows designated foreign securities firms—about half of which to date have been U.S. companies—to purchase domestic Chinese financial instruments.[2] Because China's capital markets are still in the early stages of development and lack transparency and a regulatory framework comparable to that of the United States, this situation raises significant governance, financial risk, and potential security-related concerns for qualified U.S. investors purchasing these equities.
- China's state-owned banks and financial institutions continue to contribute to China's economic boom through massive, politically driven lending, often based on noncommercial criteria. As a result, these institutions currently have nonperforming loans (NPLs) estimated to be approximately $500 billion.[3] Since China's loan growth in the first quarter of 2004 grew by twenty-one percent over the previous year, the total NPL level will likely rise as the poor quality of these loans becomes known.[4] China's

WTO commitments require the country to open its financial sector to foreign competition five years after accession, or in 2006. However, due to the massive NPL problem many Chinese banks are technically insolvent and unlikely to be able to compete successfully with foreign banks. Thus, it seems unlikely that China will succeed in opening its financial sector in accordance with its WTO commitments.

- Chinese firms are not subject to accounting, transparency, and corporate governance standards consistent with U.S. norms. While the Sarbanes-Oxley Act of 2002 improved disclosure requirements for foreign issuers in the U.S. markets, U.S. investors still lack adequate information about Chinese firms and sufficient investigative mechanisms to ensure Chinese firms are meeting disclosure requirements with respect to material risks to investors. A recent Securities and Exchange Commission (SEC) probe into New York Stock Exchange (NYSE)-listed China Life's accounting irregularities and a trade secret theft and patent infringement suit brought in U.S. courts against NYSE-listed Semiconductor Manufacturing International Corp. (SMIC) underscore this problem.
- Mutual funds that invest in China—so called "China funds"—must do so on the basis of limited and often inaccurate information. It is rare for Chinese companies' financial information to be accessible to the public. As a result, China fund investors are considerably more reliant on their fund managers' due diligence than is common. This concern is compounded when large funds outsource due diligence to small-or medium-sized firms in Hong Kong, a routine practice.
- The Commission remains concerned about the nexus between Chinese firms listing on U.S. and international capital markets and weapons proliferation and China's defense-industrial complex. The U.S. government lacks adequate interagency coordination, regulatory resources, and information collection management to monitor and disclose these important relationships, which are critical to U.S. national security and may represent a material risk to investors. In addition, underwriters have not exercised appropriate vigilance in seeking out this information as part of their due diligence.

OVERVIEW

The Chinese government has an interest in facilitating Chinese company listings on global capital markets, particularly the New York and Hong Kong stock exchanges. Such listings are predicted to generate approximately $23 billion in 2004 alone.[5] China's underdeveloped domestic capital markets cannot meet the country's financial needs; thus, the Hong Kong and New York exchanges have become vital sources of capital for Chinese companies. However, China's lack of standardized and enforceable accounting and corporate governance regulations raises troubling issues from both an investor and a national security perspective.

China's legal and regulatory shortcomings present a major challenge to investors interested in purchasing a U.S.-listed Chinese stock or China-focused mutual fund, as well as analysts tasked with unraveling Chinese companies' complex web of relationships and finances. The SEC recently announced a probe into NYSE-listed China Life's accounting irregularities, and a trade secret theft and patent infringement suit has been brought in U.S. courts against NYSE-listed SMIC. These cases appear to have cooled investors' appetite for Chinese initial public offerings (IPOs) for the moment. With an estimated $23 billion in initial public offerings planned for 2004, however, China shows no signs of slowing the pace of listings.[6]

The Commission also remains concerned about the identities and activities of certain Chinese firms available for debt and equity purchases by U.S. investors and whether these firms pose security and financial risks. Questions remain regarding whether sufficient, disclosure-oriented regulations are in place to monitor this activity and whether U.S. investors are adequately informed about the true identity of Chinese companies, their senior management, and the nature of their overseas operations and parent and subsidiary relationships. Given the commingled nature of China's commercial firms and China's defense-industrial sector, it is essential for the U.S. government and U.S. investors to understand more fully the relationship between Chinese firms raising money in the global capital markets and the Chinese military and defense establishment. The NORINCO (China North Industries Corporation) case illustrates that listed Chinese companies may be involved in weapons proliferation.[7]

ANALYSIS AND FINDINGS

China's Financial and Banking Structure

China's banking sector is dominated by the country's top four commercial banks: Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), and China Construction Bank (CCB). These institutions account for some seventy-five percent of the PRC's total banking assets.[8] At the end of 2001, these four banks alone had 1.4 million employees and 116,000 branches.[9]

Four regulatory bodies govern China's financial sector. The China Securities Regulatory Commission (CSRC), which is modeled on the SEC, is the most far reaching. It formulates and oversees the policies, plans, and laws regulating securities and futures listings. The State Economic and Trade Commission (SETC), a component of the state council, organizes overall national economic plans and industrial policy and also develops the investment plan for nonmonopoly sectors of China's economy. Other government organizations involved in regulating China's financial structure are the Ministry of Finance and the People's Bank of China, the central bank of the PRC.

China's state-owned banks are beset by a nonperforming loan crisis. For decades, in an effort to maintain economic and social stability, the government encouraged banks to lend heavily to prop up failing SOEs.[10] In his testimony before the Commission, Professor Pieter Bottelier described this so-called policy lending and its result: "By allowing the State sector to continue expanding output and employment through easy access to State bank credit (until about 1995), China preserved full urban employment and growth dynamics throughout the initial stages of its economic transformation, but in doing so, also created the NPL problem." [11] In effect, the big four banks have been left essentially insolvent.

A comparison that helps put the scale of China's NPL crisis in perspective is the U.S. savings and loans (S&L) crisis of the late 1980s. Following the wave of deregulation of U.S. financial markets in the early 1980s, the U.S. S&L industry embarked on a speculative lending boom that ultimately led to widespread bankruptcies and the accumulation of a massive portfolio of bad loans. To clean up this problem, Congress established the Resolution Trust Corporation (RTC) in 1989, charging it with taking over bankrupt S&Ls and selling off their assets. The total value of assets and loans taken over and sold by the RTC was $500 billion, approximately nine percent of 1989 U.S. GDP.[12] As a percentage of GDP, China's banking crisis is far larger. Goldman Sachs estimates it would cost China between forty-four and sixty-eight percent of GDP to solve the NPL crisis.[13] The scale of the NPL crisis in China is estimated to be approximately $500 billion.[14] The value of the underlying assets supporting these loans is unknown. However, given that they have often been made on political grounds and for purposes of keeping alive loss-making companies, it is probably fairly low.

Chinese financial institutions have attempted in recent years to purge their books of NPLs through a combination of auctions, direct sales, and joint ventures. While these have often come via transfers of NPLs to China's four asset management companies, in early 2004 state-owned banks began to sell off the assets directly. So far, China's attempts to offload NPLs have met with mixed results. Despite Citigroup's April 2004 purchase of NPLs with a face value of $242 million, recently, the Chinese authorities blocked the sale of over $520 million worth of NPLs by China Construction Bank to Morgan Stanley and forced the Bank of China to delay indefinitely a planned NPL auction valued at $724 million. Both sales were blocked by Beijing because they came at too low a price. This suggests that in 2004 "the market for disposing of NPLs in China is in trouble." [15]

Perhaps most troubling is that China continues to use noncommercially justified bank lending to promote growth and investment. Total bank lending increased dramatically in 2003 and in the first quarter of 2004 grew twenty-one percent over the previous year.[16] As a result of this vast new expansion of bank credit, many loans will likely end up as nonperforming and therefore risk undermining the measures that China has taken to work through its existing NPL crisis.[17] In short, despite China's efforts to reduce money supply growth (e.g., selling bank bills, raising reserve requirements and placing a brief moratorium on bank lending) the politicized nature of the lending system means that banks will probably continue to generate bad loans.

With Chinese banks seeking listings on global capital markets, the implications for investors are serious. For instance, investors buying shares in the Industrial and Commercial Bank of China, China Construction Bank, or Bank of China (all of which are scheduled to list on the NYSE in the next two years [18]) could be misled by restructured balance sheets and unknowingly purchase a pool of fresh loans that are likely to be uncollectible.[19]

Furthermore, loans that are disbursed by state-owned banks at preferential rates and without the expectation of reimbursement may constitute WTO-inconsistent government subsidies. These loans are made to Chinese exporters, and go to domestic producers who compete with foreign firms. For example, in 2003, financial institutions were required to issue loans in accordance with industrial policies.[20] These subsidies give Chinese companies an unfair advantage over foreign competitors and as a result appear to be inconsistent with WTO regulations.

In some cases, China is seeking to increase foreign ownership of its healthier banks. In December 2003, the China Banking Regulatory Commission granted approval to BNP Paribas (France) to purchase a fifty percent stake in the Industrial and Commercial Bank of China's joint venture bank, the International Bank of Paris and Shanghai. This bank, renamed BNP Paribas (China) Limited, is China's first foreign-owned, locally incorporated bank.[21] China's goal in allowing foreign investment into its banking sector is, in part, to improve the banks' financial health and lending standards.

PRC Corporate Governance and Accounting Standards

China's legal framework for corporate governance is largely contained within the CSRC's Code of Corporate Governance of Listed Companies in China. In addition, the Certified Accountant Law (1993), Audit Law (1994), Company Law (1994), People's Bank of China Law (1995), Commercial Bank Law (1995), Securities Law (1998), and Accounting Law (1999) provide the framework for China's domestic capital markets.[22] Due to inadequate enforcement capability, regulations governing the state-company relationship are not always implemented.[23]

On the surface, listing shares of state-run firms in global capital markets should dilute state control and increase accountability to investors. Paradoxically, it may in fact serve only to expand the resources under state control. As explained by Professor Donald Clarke, of the University of Washington School of Law:

> *China Telecom Corporation Limited (CTCL) is a shareholding limited company with shares listed on the New York and Hong Kong stock exchanges. Almost 80 percent of its stock, however, is owned by China Telecom Group Company, a traditional SOE with no shares that is directly owned by the Chinese government, while less than 12 percent of the equity was sold to the public. By creating a controlled subsidiary in the form of a shareholding company and selling a small proportion of its shares to the public, the parent SOE actually increased the value of assets under state control.*[24]

Chinese corporate governance standards lag far behind the United States. One problem is the state's continued control over resource allocation.[25] The legal framework enshrines a top-down management structure that obstructs the operation of market forces. As a result, even if laws were properly implemented, the results would not be economically efficient.[26]

A second problem concerns minority shareholder rights. Cronyism, insider dealings, and rubber stamp shareholder meetings remain principal causes of investor powerlessness.[27] Because foreign investors are forbidden from holding a controlling interest in Chinese firms, the majority shareholder (the government, in the case of an SOE) can ignore minority investors' demands for upgraded corporate governance, transparency, and accountability.[28]

A third problem is the lack of a sound credit rating system. In part, this is due to poor corporate accounting practices that make it exceedingly difficult to rate Chinese companies. Another major inhibitor is the Chinese government. Companies need permission from the government before they can approach a credit rating agency, and Chinese law allows firms to keep their rating confidential.[29] According to Standard & Poor's, Chinese companies frequently pull out of the ratings process if they receive a bad rating. To date, credit rating agencies have given high ratings to Chinese companies based on the overall economy's impressive economic growth and the government's support of banks and SOEs.[30] By and large, Chinese firms' high domestic credit ratings are a reflection of implicit government guarantees rather than the health of the company or industry.

China does not follow international accounting standards. This represents a major roadblock to transparent corporate governance. For example, a 2002 survey done by CSRC revealed that one in ten listed companies had doctored its books and, in January 2004, China's Finance Ministry reported that 152 firms had misstated profits by a combined $350 million.[31] PRC officials estimate that China needs three hundred thousand qualified accountants, while other independent estimates are closer to four million. To address this shortage, Beijing has opened two national accounting institutes to train accountants in international accounting methods. The Chinese government is also requiring publicly held companies to report financial data every quarter rather than every six months.[32]

China's state-run firms are plagued with accounting irregularities. An egregious example of inadequate disclosure was recently discovered at China Life, China's biggest insurer. The SEC is investigating an alleged $652 million fraud,[33] and investigators in Hong Kong and on the mainland are looking into allegations of high-level insider dealings.[34] In a telling comment, indicative of the clientelist relationship between Chinese companies and the government, China's finance minister, Jin Renqing, came swiftly to China Life's defense, claiming the company had "behaved very openly" in the run-up to its IPO.[35] China Life issued the world's largest IPO in 2003—$3.4 billion. Another example is SMIC, which has acknowledged that an executive had made "inaccurate statements" about the company's ability to meet expenditures through 2005.[36]

China is making some efforts to improve its corporate governance standards. Many small and medium-sized Chinese firms seeking to list in the United States are improving transparency and accounting practices in an effort to adhere to SEC regulations. On the domestic side, in early 2002, CSRC issued the Code of Corporate Governance of Listed Companies, which raised standards for accounting procedures and information disclosure. Another development came in January 2003, when China's "highest court said that shareholders could file individual or class-action lawsuits against companies that lie about their accounts." [37] On passage of the law, about nine hundred suits were filed (there were a total of one thousand two hundred listed companies in China at the time).[38]

China's Domestic Capital Markets

China's domestic capital markets system was established to help meet SOEs' capital needs and thereby reduce the burden on Chinese state-owned banks to do so. Since the Chinese banking system still supplies Chinese businesses with ninety percent of their funding, Beijing also hopes this strategy will have the corollary benefit of reducing the state-owned banks' NPL problem.[39]

Unfortunately, providing the general public with a means of diversifying investment portfolios and hedging consumption/income risks are not among Beijing's primary reasons for encouraging its citizens to invest in its domestic capital markets.[40] The Chinese government often manipulates the markets to advance its political agenda. Rather than allowing capital markets to support the growth of vibrant private enterprises, China's leaders view them as a means to achieve social and industrial policy objectives and subsidize SOE restructuring, goals that are unrelated to market-based considerations. For example, Beijing is increasingly concerned about the strain on supplies of natural resources and raw materials caused by rising investment in heavy industry. To limit the development of these industries, the CSRC is attempting to prohibit firms in the steel, cement and aluminum sectors from undertaking new bond or share issues.[41] As a result, China's equity and bond markets lack currency convertibility, market liquidity, and an adequate range of investment instruments to guarantee moderate returns and reliable payouts.[42]

Three types of shares are sold on the Shanghai and Shenzhen stock exchanges. "A shares" are held by residents of China (and a select number of designated qualified foreign institutional investors). "B shares" are open to foreign investors. They are denominated in renminbi but payable in foreign currency. "C shares" are wholly owned by SOEs and are not publicly traded. In January 2004, there were 1,290 A and B share listed companies in China, [43] and total market capitalization in China's capital markets was $532 billion or forty percent of GDP. This figure is expected to rise to $850 billion (forty-seven percent of GDP) and $1.35 trillion (sixty percent of GDP) by 2007 and 2010, respectively.[44] Originally, China established the B share market to boost domestic firms' access to foreign capital. However, this strategy has had only limited success. In response, China has begun to open the A share market to QFIIs.

The Chinese government has undertaken measures to improve the liquidity and transparency of its domestic capital markets. The State Council has set forth a list of reforms necessary for achieving these goals. These include strengthening institutional investors, increasing financing channels for securities companies, and attracting new sources of funds into the market.[45] The PRC has also recruited foreigners to help upgrade its securities market. For example, Anthony Neoh, a former chair of the Hong Kong Securities and Futures Commission, was hired as chief advisor to the CSRC, and Laura Cha, a highly respected U.S.-trained lawyer with legal experience in both the United States and Hong Kong and former Hong Kong Securities and Futures Commission vice-chair, was hired as CSRC vice-chair.[46]

The Chinese government is also working to reform its domestic debt markets. The corporate bond market is currently small. Only $3.9 billion in corporate bonds were issued in 2002. Sovereign bonds accounted for $568 billion, compared with $8 trillion in U.S. Treasuries. Last year, China raised $1 billion in dollar-denominated sovereign bonds and $500 million from a euro tranche.[47] While there is a demand in China for dollar-denominated corporate bonds, so far none have been issued.

To be sure, Chinese corporate governance remains a work in progress. However, the end result will not necessarily be comparable to accepted international standards. Despite reforms, China's domestic capital market system remains the domain of the SOE. Stringent listing requirements, long waiting periods, and a prohibition against restructuring during the lengthy waiting period "creates a perception and a reality to the small and medium (private) enterprises that these stock exchanges do not want them."[48]

China's Outreach to International Capital Markets: Buyer Beware

The Chinese government facilitates and makes the decisions concerning foreign stock market listings of Chinese firms and to date has heavily favored SOEs. Although scores of Chinese firms list on the New York Stock Exchange and NASDAQ, and a handful list in London, the Hong Kong Stock Exchange has been, and likely will continue to be, the destination of choice for mainland companies seeking to raise capital in international markets. Figure 3.1 lists the IPOs for Chinese companies at home, abroad, and in the United States between 2001 and 2004.

Figure 3.1 Home, Abroad, and U.S. Initial Public Offerings of Chinese Companies (US$m Raised), 2001–04

Year	A-Share	Overseas	U.S.*
2001	4,413.04	2,364.30	1,720.7
2002	5,987.21	2,497.75	1,434.2
2003	5,037.60	6,364.88	3,098.0
2004	976.56**	22,700***	N/A

***U.S. totals are included in overseas totals.**
****Total as of March 17, 2004.**
*****Reuters' projection for 2004.**
Source: Deologic: A-Share and Overseas totals. IPO Home (*www.ipohome.com*)—U.S. totals.

Hong Kong

There are two types of mainland Chinese company listings in the Hong Kong market: "H-shares," which are companies that are floated on the Hong Kong Exchange but incorporated in the mainland,

and "Red Chips," which are companies incorporated and listed in Hong Kong with controlling Chinese shareholders.

Hong Kong's capital markets have benefited from Chinese companies' listings. In 2003, the Hong Kong Exchange ended at a two-and-a-half year high due primarily to mainland IPOs. Some of these new listings were oversubscribed by five hundred to seven hundred times. The largest were Property and Casualty Co., LTD (PICC), China Life, Great Wall Automobile, and Zijin Gold Mining. PricewaterhouseCoopers expects approximately one hundred firms (mostly from the mainland) to raise about $12.8 billion on Hong Kong stock market listings in 2004.[49]

The Hong Kong Exchange has undergone important regulatory changes in recent years to improve its operations and governance standards. In March 2002, the Hong Kong Legislative Council passed a new Securities and Futures Ordinance to improve the supervision and regulation of Hong Kong's financial markets. And in 2001, the last of the interest rate rules was abolished, "which brought to an end a government sponsored cartel in the banking industry."[50] Most recently, on April 1, 2004, the Hong Kong equity market banned so-called "back-door listings." This prevents firms from injecting assets into shell companies and skirting disclosure requirements necessary for proper corporate governance enforcement.[51] In an effort to beat the deadline, Chinese appliance goods giant Haier and fixed-line telecommunications company Pacific Century Ciber Works (PCCW) rushed their back-door listings to market.[52]

Unfortunately, Hong Kong's stock exchange continues to operate under an apparent conflict of interest. "The same entity which operates the Hong Kong Exchange and earns fees from such listings, Hong Kong Exchanges & Clearing, also has the authority to regulate the listings, including initial listings of companies."[53] This contrasts with the United States, where the SEC regulates the markets.

United States

At present there are approximately seventy Chinese companies listed on the American Stock Exchange, NASDAQ, or the NYSE, and the vast majority of funds raised by Chinese firms in the U.S. markets have gone to state-owned firms.[54] In March and April 2004, however, public inquiries by the SEC into the circumstances surrounding several of these listings led to some apprehension. In April 2004, Jamie Allen, secretary general of the Asian Corporate Governance Association, explained investors' reaction: "I can't say that over the past few months I saw investors being concerned about [the] corporate governance of the [Chinese] companies being listed. Now that the IPO rush seems to be slowing down, investors are becoming more concerned."[55]

The SEC's corporate governance and transparency requirements were strengthened in January 2002 pursuant to the Sarbanes-Oxley Act (P.L. 107–204). This act requires chief executive officers (CEOs) to certify the accuracy of their SEC filings and carries criminal penalties for inaccurate filings. "According to bankers, Sarbanes-Oxley is causing particular discontent among the Chinese CEOs. Their government is pushing for the country's larger companies to be listed in both Hong Kong and the United States, much to the angst of those who will take charge."[56] Even in cases where senior managers are not suspected of wrongdoing, they are wary of taking responsibility for accounting figures provided by others. "Sarbanes-Oxley has definitely raised the bar and it could be the reason why some Chinese corporates pull out."[57]

Most Chinese firms list in the U.S. capital markets using American depositary receipts (ADRs) or as foreign filers. Companies that list using these methods are subject to less stringent SEC disclosure regulations than those that list directly or through a merger. Despite these weaker reporting requirements, some of China's highest grossing IPOs, such as PetroChina, Ctrip, China Life, and China Unicom, have listed as ADRs. Individual investors are often unaware of the important differences in disclosure when choosing which Chinese companies' stock to purchase.[58]

Some Chinese firms have gained listings in the United States through reverse mergers. "It is an active and growing strategy in China for Chinese companies to become public in the U.S. not through an IPO but by merging with an existing dormant U.S. public company and then pursuing a raise of capital through the private placement markets."[59] Small—and medium—sized private Chinese firms most often use this method. There are currently thirty-one Chinese companies listed in the United States in this fashion.[60]

After a Chinese firm merges with a listed U.S. public company, the firm's accounting practices become subject to SEC regulations. "Among other factors, a board of directors with independent directors and improved internal accounting procedures serve to increase the transparency of the Chinese company to the advantage of U.S. investors."[61] However, an accounting and audit culture is important to any company's development of proper corporate governance and transparency. SEC regulation enforcement requiring cooperation from local Chinese authorities also remains a concern with Chinese firms listing in this manner.[62]

Many U.S. investors hold Chinese equities through their mutual funds. The typical China-focused mutual fund ("China Fund") invests sixty percent of its assets in Hong Kong stocks, with the remaining forty percent split between mainland and Taiwan firms. Some invest in other countries in the region or companies that have a presence in China.[63] In 2003, U.S. investors placed $835 million into such funds, a ninefold increase over 2002.[64]

Because American investors are unable to access accurate and timely information about shares listed on Chinese exchanges in Hong Kong, Shenzhen, and Shanghai, they must rely on the due diligence of mutual funds. China fund investors therefore depend almost exclusively on mutual fund managers to make decisions based on on-the-ground research. More troubling is that large fund managers often enlist small, locally based firms to perform their due diligence. This is worrisome, given the questions surrounding China's lax corporate governance and disclosure regulations. The special nature of China funds makes them particularly risky investments.

For example, a Citigroup-Smith Barney report issued on March 3, 2004, noted that the Aluminum Corporation of China Ltd.

(NYSE: ACH) "has been required to shut down 30% of production in its Guangxi Pingguo Plant due to a power shortage. We have checked with management, who deny that it is suffering power shortages, but indicate that the plant is undergoing annual maintenance."[65] Thus, Chinese mutual funds should be considered a buyer-beware investment, or, as Joe Grieco, manager of financial products for Parker/Hunter, said, "It's like buying a pack of cigarettes. We put the surgeon general's warning on it."[66]

Key recent and upcoming Chinese IPOs include the following:

- In December 2003, China Life—China's largest insurer—launched the year's largest IPO, valued at $3.46 billion. In June 2003—during a restructuring ahead of China Life's IPO—"less attractive assets" were transferred to its parent company, and China Life only retained its more desirable assets. But problems surfaced when an alleged $652 million in irregularities resulted in a class-action suit against the company in U.S. district court. As a result, probes were launched by the SEC and Hong Kong's Securities and Futures Commission into the company's dealings. Anticorruption watchdogs in Hong Kong and the mainland are also investigating allegations that friends and relatives of senior China Life Insurance executives received undisclosed "preferential treatment."[67]
- Semiconductor Manufacturing International Corp.—(SMIC) the largest manufacturer of semiconductor chips in China, launched a $1.8 billion IPO on the New York and Hong Kong stock exchanges in March 2004. Despite reports that it would "see roaring investor demand," the Shanghai-based company saw its offering fizzle.[68] SMIC shares fell eleven percent on the first day of trading, amid a storm of allegations. Taiwan Semiconductor Manufacturing, which had originally filed suit against SMIC on December 23, 2003, filed papers with a U.S. federal court on March 23, 2004, claiming it had new evidence, including "eyewitness accounts and technical verification," proving SMIC had stolen aspects of its chip design.[69] SMIC's offering came just a few days after the United States lodged a complaint with the WTO over tax breaks granted by the Chinese government to Chinese semiconductor firms. But perhaps most damaging was the company's retraction of a statement by its chief financial officer that it would not need to seek external funding for capital expenditures.[70]
- The Bank of China (BOC), with total assets of $440 billion in late 2002,[71] is reported to be preparing for an IPO in 2005. The state-owned commercial bank received $22.5 billion in December 2003 from China's central bank to rebuild financial reserves. The BOC has significant internal problems, including recent corruption scandals and an NPL level between twenty and fifty percent.[72] China's central bank says that, as part of the IPO process, BOC will be required to come up with core business strategies by the end of April 2004 and identify annual targets for the coming years.[73]
- China Construction Bank (CCB), China's third largest lending institution, is planning to make what could be a record IPO in late 2004 or 2005 worth an estimated $5 to $10 billion.[74] CCB hopes to list simultaneously on stock markets in China, Hong

Kong, and the United States. The bank, which has hired Citigroup Inc. and Morgan Stanley to lead manage the IPO, will set up a joint-stock company to own the assets it plans to list.[75] CCB is also faced with the task of reducing bad debts. Like the Bank of China, the Chinese government estimates that nearly one-fifth of CCB's loans are NPLs. But economists in China say a number between forty and fifty percent is more realistic. Chinese Premier Wen Jiabao recently criticized CCB managers for lack of commitment to reform and commercialization. CCB also received a cash infusion of $22.5 billion from China's central bank to reduce its NPL ratio.[76]

Security-Related Dimensions

During the 1980s and 1990s, China's economy was dominated by SOEs, many of which were managed by the People's Liberation Army (PLA) and were a part of China's defense-industrial complex. In 1998, in an effort to curtail corruption and return the PLA to focusing on its primary military functions, then-President Jiang Zemin called for the dissolution of this military-business structure. Divestiture served as recognition that the military should not run commercial operations.[77]

Because many of the former PLA enterprise heads transferred control to relatives or former military officers, the Commission remains concerned that these enterprises have retained unofficial links to their former PLA counterparts.[78] Moreover, the links between military and commercial production in China, particularly in SOEs, mean that foreign investors in these firms can rarely be sure of their investment's final destination. It is incumbent upon fund managers and underwriters to make investors aware of any relevant ties between China's military and companies listed in global capital markets, as such ties could be a material risk for investors.

In addition to linkages to the Chinese defense-industrial complex, the Commission continues to be concerned about the possible nexus between Chinese firms listing on U.S. and other international exchanges and weapons proliferation. The 2003 Intelligence Authorization Act (P.L.107–306 sec. 827) included a provision that required the director of Central Intelligence to report annually on whether any Chinese or other foreign companies determined to be engaged or involved in the proliferation of weapons of mass destruction (WMD) or their delivery systems have raised, or attempted to raise, funds in the U.S. capital markets. This requirement, however, was repealed in the 2004 Intelligence Authorization Act (P.L. 108–177, sec. 361e). The Commission believes there is need for a robust, coordinated effort by the U.S. government to ensure that U.S. investors are not unwittingly investing their funds in Chinese military-related firms or weapons proliferators, and that this important issue has not been accorded a high enough priority by the intelligence community. The repealed reporting provision was a solid, positive step in this direction, and the Commission believes it should be reinstated and expanded.

As of 2002, more than three-quarters of companies listed as A shares in China's capital market are state controlled.[79] These include known proliferators such as NORINCO, which was sanctioned by the U.S. government on four separate occasions in 2003 for offenses including missile proliferation and sales of equipment or expertise to Iran that could be used in a "WMD or cruise or ballistic missile" program.[80] Under the QFII program discussed above, designated foreign financial institutions can now purchase A shares directly. This means that QFIIs, about half of which are U.S. firms (including Morgan Stanley Dean Witter, Citibank Global Markets, Morgan Chase Manhattan Bank, and Goldman Sachs), can purchase the company's stock.[81] More importantly, the history of Chinese corporate nontransparency makes it difficult for investors to recognize the complex and often secretive relationships among companies, particularly with regard to state-owned entities.[82]

RECOMMENDATIONS

- The Commission recommends that Congress reinstate the reporting provision of the 2003 Intelligence Authorization Act [P.L. 107–306, Sec 827] directing the director of Central Intelligence (DCI) to prepare an annual report identifying Chinese or other foreign companies determined to be engaged or involved in the proliferation of weapons of mass destruction or their delivery systems that have raised, or attempted to raise, funds in the U.S. capital markets. The Commission further recommends that Congress expand this provision to require the DCI to undertake a broader review of the security-related concerns of Chinese firms accessing, or seeking to access, the U.S. capital markets. This should include the establishment of a new interagency process of consultations and coordination among the National Security Council, the Treasury Department, the State Department, the SEC, the Federal Bureau of Investigation (FBI), and the intelligence community regarding Chinese companies listing or seeking to list in the U.S. capital markets. The aim of such an interagency process should be to improve collection management and assign a higher priority to assessing any linkages between proliferation and other security-related concerns and Chinese companies, including their parents and subsidiaries, with a presence in the U.S. capital markets.
- The Commission recommends that Congress require mutual funds to more fully disclose the specific risks of investments in China. This should include disclosure to investors of the identities of any local firms subcontracted by funds to perform due diligence on Chinese firms held in their portfolios. Subcontractors' principal researchers, location, experience, and potential conflicts of interest should all be disclosed.
- The Commission recommends that Congress direct the Commerce Department and USTR to evaluate whether Chinese state-owned banks' practice of noncommercial-based policy lending to state-owned and other enterprises constitutes an actionable WTO-inconsistent government subsidy and include this evaluation in the report on subsidies recommended in Chapter 1.
- In its 2002 Report, the Commission recommended that Congress prohibit debt or equity offerings in U.S. capital markets by any Chinese or foreign entity upon which the State Department has imposed sanctions for engaging in the proliferation of weapons of mass destruction or ballistic missile delivery systems. The

Commission further believes that Congress should bar U.S. institutional or private investors from making debt or equity investments, directly or indirectly, in firms identified and sanctioned by the U.S. government for weapons proliferation-related activities, whether they are listed and traded in the United States or in the Chinese or other international capital markets. For example, NORINCO, a company sanctioned by the U.S. government, is currently available for purchase on the Chinese A share market. U.S.-based qualified foreign institutional investors that have rights to trade on this exchange should not be permitted to invest in NORINCO or any other firm officially determined to have engaged in the proliferation of WMD or ballistic missiles.

Appendix A
Chinese Public Companies Listed in the United States*

Name	Symbol	U.S. Filer	Foreign Filer	Foreign Filer ADR
Aluminum Corp. of China Ltd.	ACH			x
American Oriental Bioengineering, Inc.	AOBO	x		
AP Henderson Group	APHG	x		
Asiainfo Holdings, Inc.	ASIA	x		
ASAT Holdings Ltd.	ASTT			x
AXM Pharma, Inc.	AXJ	x		
Stratabid Com, Inc	BBOI	x		
Bluepoint Linux Software Corp.	BLPT	x		
Bonso Electronics International, Inc.	BNSO		x	
Beijing Yanhua Petrochemical Co.	BYH			x
China Automotive Systems, Inc.	CAAS	x		
Brilliance China Automotive Holdings Ltd.	CBA			x
China Cable & Communication, Inc.	CCCI	x		
China Eastern Airlines Corporation Ltd.	CEA			x
China National Offshore Oil Corp.	CEO			x
China Telecom Corporation Ltd	CHA			x
China Continental, Inc./UT/	CHCL	x		
Chindex International, Inc.	CHDX	x		
Chinadotcom	CHINA		x	
China Mobile Hong Kong Ltd.	CHL			x
China Resources Development, Inc.	CHRB	x		
China Unicom	CHU			x
Communication Intelligence Corp.	CICI	x		
Euro Tech Holdings Co Ltd	CLWT		x	
Ctrip.com	CTRP			x
China Wireless Communications, Inc.	CWLC	x		
China Yuchai International Ltd.	CYD			x
DF China Technology, Inc.	DFCT			x
Deswell Industries, Inc.	DSWL		x	

Appendix A—Continued
Chinese Public Companies Listed in the United States*

Name	Symbol	U.S. Filer	Foreign Filer	Foreign Filer ADR
Far East Energy Corp.	FEEC	x		
Forlink Software Corp, Inc.	FRLK	x		
Graphon Corp/DE	GOJO	x		
Guangshen Railway Corporation Ltd.	GSH			x
Genesis Technology Group, Inc.	GTEC	x		
Highway Holdings Ltd.	HIHO		x	
HuaNeng Power International, Inc.	HNP			x
Hartcourt Companies, Inc.	HRCT	x		
Industries International, Inc.	IDUL	x		
Intermost Corp.	IMOT	x		
INTAC International	INTN	x		
LJ International, Inc.	JADE		x	
Jilin Chemical Industrial	JCC			x
JinPan International Ltd.	JST			x
China Life Insurance Co Ltd.	LFC			x
Largo Vista Group Ltd.	LGOV	x		
Linktone Ltd.	LTON			x
Nam Tai Electronics, Inc.	NTE		x	
Netease.com, Inc.	NTES			x
New Dragon Asia Corp.	NWD	x		
Pacificnet, Inc.	PACT	x		
Peak International Ltd	PEAK	x		
PetroChina Company	PTR			x
Radica Games Ltd	RADA		x	
Sinopec Shanghai Petrochemical Co.	SHI			x
Sina Corp.	SINA	x		
Smith Investment Co.	SMIC		x	
China Petro and Chem Corp (Sinopec)	SNP			x
Sinovac Biotech Ltd.	SNVBF		x	
Sohu.com, Inc.	SOHU	x		

Appendix A—Continued
Chinese Public Companies Listed in the United States*

Name	Symbol	U.S. Filer	Foreign Filer	Foreign Filer ADR
Tiens Biotech Group USA Inc.	TBGU	x		
TengTu International Corp.	TNTU	x		
Tom Online, Inc.	TOMO			x
UTStarcom, Inc	UTSI	x		
Webzen Inc.	WZEN		x	
Qiao Xing Universal Telephone, Inc.	XING			x
Xin Net Corp.	XNET	x		
Yi Wan Group, Inc.	YIWA	x		
Yanzhou Coal Mining Co.	YZC			x
Zi Corp.	ZICA		x	
Zindart Ltd	ZNDT			x
China Southern Airlines	ZNH			x
Total	**71**	**32**	**12**	**27**

*This chart may not be exhaustive.
Source: Halter Financial Group, Dallas, TX.

Appendix B
Expected Chinese IPO's in Global Capital Markets in 2004
Total Expected IPO's ~ $22.7 billion

Company	Size of Deal
Semiconductor Manufacturing International Corp (SMIC)	$1.8 billion
China Oriental Group	246.8 million
Shanghai Forte Land	220.8 million
Weichai Power Co Ltd	148.7 million
Linktone Ltd	86 million
China Green (Holdings)	28.3 million
China Construction Bank	5–10 billion*
Ping An Insurance	2 billion*
China Netcom	1.5–3 billion*
Shenhua Group	1.5 billion*
Minsheng Bank	1 billion*
Air China	500 million*
China Power	500 million*
Shenzhen Energy	500 million*
Tangshan Guofeng Steel Co Ltd	500 million*
Tencent Technology	250 million*
CSMC Technologies Corp	200 million*
Mengniu Dairy	128 million*
China Group Corp	128 million*
Total completed deals	**2.5 billion**
Total possible upcoming IPOs	**20.2 billion***

*Estimated
Source: Reuters (as appeared on www.forbes.com)

Appendix C
Chinese Companies' IPOs: US$ Billions Raised in International Capital Markets, 2001–2004

Sources: 2001–2003; Dealogic; 2004 Reuters (projection).

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